

ESG challenges for small and mid-caps



Mario Nava

Director Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

European Commission work on non-financial reporting

The European Green Deal has put Europe on the path to become the first climate-neutral continent in the world by 2050. The Commission recently took a big step in that direction by unveiling its proposal for the first ever European Climate Law.

By the end of 2020, the European Commission will also put forward a new

Sustainable Finance Strategy, as well as proposals to revise the Non-Financial Reporting Directive.

Currently there is a sustainability reporting gap. The needs of investors for corporate sustainability information are increasing faster than any improvements in company reporting. There is plenty of evidence that the non-financial information reported by companies is not sufficiently comparable, reliable or complete.

Non-financial reporting from investee companies will need to improve to enable the financial sector to meet its own legal obligations to report certain sustainability-related information under new European laws – in particular the taxonomy Regulation and the regulation on sustainability disclosures by investors.

At the same time, the current situation is also unsatisfactory for reporting companies. They face uncertainty and complexity when faced with an array of overlapping and inconsistent private non-financial reporting standards and frameworks. And they are under pressure to respond to additional demands for non-financial information from sustainability rating agencies, data providers and civil society, irrespective of the information that they publish as a result of existing European reporting rules.

In parallel to the development of a legislative proposal to revise the Non-Financial Reporting Directive itself, Vice-President Dombrovskis, has announced the

launch of a process to develop European non-financial reporting standards. Not every detail can – or should – be fixed in law. There is also a need for clear reporting standards for companies to apply.

The EU cannot develop such standards on its own. While we are well placed to take the lead, the EU will need work closely with existing private standard-setters such as the Global Reporting Initiative and the Sustainability Accounting Standards Board. We will incorporate the best and most widely accepted elements of existing standards, even though none of them on their fully meet European needs. This cannot be a question of reinventing the wheel.

Our work on non-financial reporting will have to strike a balance between the information needs of users, primarily the investment community, and the ability of investee companies to collect and report such information. We will need to play close attention to the potential costs of stronger non-financial reporting requirements, and compare them to the costs of not taking action.

We have contracted consultants to gather better data on the costs of non-financial reporting. We will also gather feedback from a major online consultation that is open until Mid-May, and from a separate survey targeted to SMEs.

Our aim is to enable the financial sector and companies to realise their full potential as catalysts for the transition to a sustainable economic system in Europe. ●

Yann Pouëzat

Director for Corporate Financing and Financial Markets, French Treasury, Ministry of Economy and Finance, France

Policies challenges for addressing standardized ESG adoption

Since the Paris Agreement in 2015, various institutional and normative initiatives have emerged to foster more transparency and long-termism in the economy. The fight against climate change requires to involve the financial system into the path of energy transition.

The ambition to redirect financial flows towards a more sustainable economy has been partly made more tangible. However, the absence of convergence around a

common definition of ‘sustainability’ prevents companies from appropriately disclosing the degree of environmental sustainability of their economic activities. In this regard, the future adoption of the European Taxonomy in 2020 - classifying the economic activities regarding their sustainable impact - has a strategic role to play in helping investors define their investment policies accordingly. Thus, this common language and the associated regulatory efforts are essential ►



► to tackle the existing challenges regarding the corporate issuer's disclosure of environmental, social and governance (ESG) information and consequently sustainable investing.

The European Union, through its Action Plan for sustainable finance, has incorporated some new reporting requirements on the sustainable impact of investments in the existing regulations applying to financial markets. However, the multiplicity of

non-comparable ESG information reflects the different approaches to corporate issuer disclosure and scoring system frameworks. European public policy initiatives shall help to streamline the number of different corporate disclosure frameworks which – as strong as they may appear – blur the readability of the ESG information among different corporate issuers and incur significant costs. By delivering some proportionate policy measures to corporate issuers, the EU shall focus, as first step, on promoting a better global alignment of the different ESG indicators. Nonetheless, the normative character of the EU future policies will have to avoid the risk of excessive granularity and the restriction over investors or rating agencies' innovation upon indicator measurements.

This common sustainable reporting framework makes it necessary to adapt this requirement to the capacity of each corporate issuer. As clear disclosure from small and mid-caps becomes scarce, the reliance by investors or insurers on every kind of data can give rise to a somewhat misleading image of smaller companies' ESG criteria adoption. The establishment of a pragmatic common reporting framework

consistent with corporate issuers' resources is a key success factor for the development of sustainable investment.

“The multiplicity of ESG information reflects the different approaches to corporate issuer disclosure and scoring system frameworks.”

The common objective to achieve a higher quality and comparable ESG data cannot be disconnected from the ambition to adjust our real economy. Europe must be able to respond to the concrete expectations of its citizens with regard to the energy transition. To this end, the social dimension, as one of the pillar of the ESG criterias, should be acknowledged through the simplicity of the ambitious framework required. This makes it necessary to take into account operational complexities for the incorporation of ESG information in order to consider the sustainability impact as a key element of the corporate strategy. ●

Carmine Di Noia

Commissioner, Italian Securities and Exchange Commission (CONSOB)

No obligations but market-based drivers to successful ESG adoption by SMEs

The publication of non-financing reports among listed SMEs is still limited. Lack of communication obviously doesn't necessary imply absence of adoption, but it would appear quite bizarre a company embracing ESG philosophy in its internal processes then “forgetting” to ride the wave of current ESG hype.

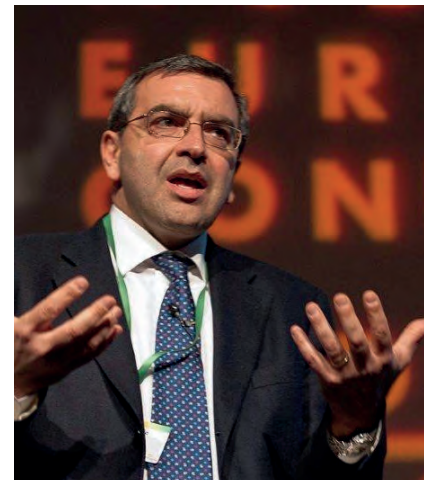
Integrating ESG factors into managerial thinking, however, is a revolution under way, not a simple fad. Temptation to “prompt” revolutionary change in business by means of rulemaking is always around the corner. No surprise that the Consultation

Document on the Review of NFRD, thus, proposes, as one possible response to the lag in non-financial reporting, the enlargement of the disclosure duties also to small/unlisted undertakings.

I do not think this is the best way to convince SMEs of the potential embedded into a shift of their strategic planning towards a long-term, sustainable horizon. Regulatory actions, with its unavoidably but burdensome solutions, should leave the floor to sound and progressive market-based evolutions. EU Institutions have already put in place the regulatory framework to favor spreading of ESG-compliant strategies (also) among SMEs: this is Capital Markets Union.

“Demand for ESG values from long-term investors is the best way for SMEs towards sustainability.”

The initial 2015 Action Plan strongly addressed SMEs funding needs by



proposing measures aiming at broadening market-based financing. The goal to enlarge the so-called “funding elevator” was pivotal in the Action Plan, with particular regard to the equity side (venture capital and private equity) and, more in general, the supply of “patient capital” suitable for convincing (small) companies to abandon short-term approach for a more sustainable ►

► management. 2017 Mid-term Review went further on outlining that a “deep re-engineering of the financial system is necessary for investments to become more sustainable and for the system to promote truly sustainable development from an economic, social and environmental perspective”. Recent Report of The Next CMU High-Level Group stressed the sustainable character of CMU to the point that proposed a re-branding the

entire project “Savings and Sustainable Investment Union”.

Tools to spread ESG among SMEs are already present in the CMU logic and measures. A full deployment of the regulatory actions, reinforced by a strong injection of fiscal incentives, should boost long-term investment by both institutional and retail investor. This should in turn bring to light the need for a longer-term

orientation of the goal of small firms: a sustainable strategy, an improved governance and a management focused on social and environmental targets. A successful development of market-based sustainable finance, in conclusion, is the market response to the problem: favoring demand for ESG values and data from sustainable long-term investors is the best way to persuade innovative SMEs to take meaningful steps towards sustainability. ●



Christophe Bourdillon

Chief Executive Officer,
CDC Croissance

ESG integration by small- and mid-cap companies: a difficult yet essential transition

The major movement to promote the imperatives of an ESG approach in the contemporary economy now seems to be irrevocably under way. The European Union aims to play an important role in this transition, by pursuing a proactive soft power strategy for green growth, as recently adopted by the Commission. Sustainable finance is the key lever for action in this area.

For several years, the EU has been engaged in work to gradually establish

a framework, including a taxonomy and guidelines, aimed at encouraging investors to systematically embed the analysis of multiple ESG factors in their asset allocation decision processes. National authorities throughout Europe have reaffirmed this approach, which has already been taken on board in the large-cap sector, where many companies have put in place substantial measures to ensure better dialogue with the financial ecosystem (stock exchanges, investors, issuers, NGOs, rating agencies, regulators, etc.).

The situation is entirely different for small- and mid-cap (SMID) companies, which tend to be more varied in terms of capitalisation (from several hundred thousand to about five billion euros) and available resources. Investors are becoming more aware every day of just how much this sector, with a few brilliant exceptions, is failing to embrace such an approach. The reasons for this astonishing unpreparedness range from a lack of knowledge to an existential fear brought about by developments confusedly perceived more as threats than as opportunities. Companies in the sector are discouraged by the methodological complexity (with a multitude of factors to be analysed and reported) and the cost of the transition to a business model that includes ESG considerations.

But the stakes could not be higher, since it is SMID companies, and more generally SMEs, that are the backbone of the European economy. There is thus a risk that, in the absence of proportionate action, these companies could be eliminated in coming years from asset allocation strategies, raising crucial financing issues for them and endangering their very survival. The same

is true for intermediaries specialised in the SMID sector, already deeply affected by the transformation of the investment research industry due to the arrival of MiFID II.

“The firm is studying the feasibility of an ESG fund based on a “best efforts” investment philosophy ...

As a leading investor in French SMID companies, the equity fund management firm CDC Croissance, a subsidiary of the state-owned Caisse des Dépôts group, has decided to opt for a persuasive approach. The firm is studying the feasibility of an ESG fund based on a “best efforts” investment philosophy, rather than the more commonly applied best-in-class approach.

The aim will be to select listed companies not among the top ESG performers, but instead having prepared for ESG integration only to a minimal or moderate extent and that will agree to engage in a gradual and measurable adaptation process.

The fund, with a target size of €100 million, is expected to begin operations in mid-2020 using a specific methodology. It is anticipated that its launch will coincide with that of an ESG SMID index, designed by Euronext NV and the Ethifinance rating agency.

This new fund should thus become part of an intense mobilisation effort driven by European and national authorities to implement a distinct and gradual adaptation process for SMEs, in order to support their transition towards more sustainable business models. ●



Rami Feghali

Partner, PwC

There is still a long way to go

Sustainable Finance is considered as a central tool to drive the real economy towards sustainability targets such as carbon neutrality by 2050. There is still however a long way to go. The share of ESG financial assets is currently less than two percents of total financial assets. Time is also running out, if we want to meet the carbon neutrality target by 2050 then the required infrastructure investments which are long term by nature must be fully sustainable by 2025.

Significant investments and progress are therefore needed within the next five years. A key underlying building block of sustainable finance is however missing. The transition of the 98% remaining financial assets can not be achieved without the availability of appropriate ESG data. There is a wide recognition among financial institutions that ESG data are incomplete, not comparable and of poor quality. This is true for all categories of ESG data, environment, social and governance, and it also true for all categories of companies although the issue is more acute for climate related data and for SMEs.

The gap between financial institutions regulatory requirements on climate risk and the ability of these institutions to comply with them based on the information they have at their disposal will be hard to close. The transmission mechanism can then be broken and instead of steering transition, finance might ultimately exclude those companies that need most support on a fair transition journey: environmental sensitive companies and smaller companies.

No one would think of a financial ecosystem operating without financial statements. We need a non financial reporting framework of the same quality as the financial reporting framework. This would be beneficial for the development of sustainable finance, but it will also be key to structure the transition journey

of the real economy. Non financial information is actually more diverse, granular and complex than financial information. It requires a reporting on a set of relevant exposure indicators, ideally by sector, location and company, and even ultimately measuring the impact of such indicators through the whole value chain. It took hundreds of years to build the financial statements that we currently use, by capitalizing on best practices and adopting progressive standardization. We only have five years ahead of us.

“Sustainable Finance can not be successful without the appropriate non financial reporting framework.”

The revision of Non Financial Reporting Directive is a unique opportunity in that respect, provided it includes a binding standardization of a minimum set of ESG indicators and an appropriate accountability framework. Given its leadership on sustainability and its political legitimacy, the European Union is best placed to build on the multiple existing reporting frameworks and find a solution. This solution can later be refined and form the basis of a global reporting framework. It is not a matter of sovereignty, perfection or excessive regulation. It is a matter of urgency and efficiency. ●

Pervenche Berès

MEP from 1994 to 2019,
European Parliament

Why Small and Mid-caps should welcome non-financial reporting

EU non-financial reporting is this part of information that financial reporting in itself cannot deliver even though they are key to value security and stability of financial markets. The answers to the Covid-19 should not water down this need.

In its February 2020 consultation document on the review of the non-financial reporting directive (NFRD), the Commission questions (cf. 40) expanding the “scope to include all EU companies with securities listed in regulated markets, regardless of their size”. Earlier, the Commission had acknowledged that to widen the scope of the directive “could reduce the burden for companies of having to respond to individual requests for information from sustainability rating agencies and data providers”.

But before answering the scope, one should consider aspects affecting any companies. The development of non-financial reporting should not be seen as a way for green washing or to develop ►



► a new hierarchy regarding financial reporting. The quality of the latter is a pre-condition for the former. The current legal tool is a directive with options for Member States. There are now strong arguments to move to a regulation. For example, one area where this option regime has proved to create damage and confusion is when it comes to the control regime.

The proper format should be a compulsory control by third-party independent bodies. The foreseeable review of NFRD is also an opportunity to clarify what is the standard for this reporting, to start with the format including obligation related to prospectus or key information document. But this could also be an opportunity to build a common culture around the Task force on climate related financial disclosures (TCFD) recommendations taking into account the entry into force of the taxonomy. One of the questions that will need to be answered is how to

increase comparability and consistency between companies reporting without jeopardizing innovation or capacity of a reporting format to capture the specificity of a business.

It would be in the best interest of Small and Mid-Caps to enter the scoop of non-financial reporting because more and more investors will ask for it.

Currently NFRD only applies to Public-interest entities with more than 500 employees, large banks and insurances listed or not. It allows Member state to define a wider scope, option that has been used by some Member states. In terms of competition and internal market, it would be more appropriate to close this option with a regulation. Regarding Small

and Mid-Caps, one could argue that it would be in their best interest to enter the scoop of non-financial reporting because more and more investors will ask for it, it will become part of a business model and it will help the due diligence process when, following the OECD guidance, “enterprises should carry out to identify, prevent, mitigate and account for how they address these actual and potential adverse impacts in their own operations, their supply chain and other business relationships“.

The question could then arise, should this be accompanied by three categories standards: compulsory, recommended and encouraged to adjust the proportionality argument? One could also consider in which sector the Mid cap is active to define its obligations. But in the end, it should be recalled that nature of risk doesn't always relate to the size of the business, this is true for financial risk, no doubt it is also true for non-financial ones. ●



Anamarija Staničić

Head of Division, Policy and International Cooperation Division, Croatian Financial Services Supervisory Agency (HANFA)

SMEs and ESGs – what is in it for me?

Small and medium enterprises (SMEs) are the backbone of the EU economy.

In 2015, just 0.2 % of all enterprises had 250 or more persons employed and were classified as large enterprises. If the EU wants to move towards a sustainable future, SMEs have to be a large part of the agenda. Another consideration is – if a thriving SME sector is an engine for growth, what impact will the adoption of Environmental, social and governance (ESG) criteria have on the business performance of SMEs, and consequently on the growth of the EU economy?

The existing subset of already ESG conscious SMEs aside, when taking up ESG criteria, a natural question will be – what is in it for me? Long term, there may be benefits for SMEs to adapt their business model to the new framework, but taking the long view may be difficult for a small business trying to keep its head above water, especially in the context of the on-going crisis.

Here, the key will be setting up the right incentives. The first step was the sustainable finance package – the taxonomy, the disclosure framework for financial market participants (FMPs) and the changes to the benchmark regulation. The second will be the changes to the Non-Financial Reporting Directive (NFRD), where the Commission is consulting on

broadening the scope of the NFRD to SMEs. Short-term, this implies an increase in the reporting burden for SMEs, which should be accompanied by an equivalent regulatory burden decrease elsewhere.

The success of the sustainability agenda depends on the EU being able to explain to SMEs how they will profit from the take-up of ESG criteria.

SMEs will also need a robust support network to help them adapt, both on a national and on an EU level. This is an opportunity for financial intermediaries to branch out and offer support to SMEs, both in implementing ESG strategic planning and external reporting, and getting SMEs the funds they need to do this while growing their business.

The larger issue is that SMEs need to see what the advantages for them are, and they need to see them now. We need to figure out how to make the ESG transition profitable for SMEs. Consumer demand for sustainable products and services will be a main driver for ►

► change in business models, and the market does not naturally reward sensible behaviour, nor do consumers naturally flock to more socially responsible firms. The supply and demand chain does not have in-built ethical considerations and is an engine devoted to making a profit. If we want to change that, we will have to build-in counterweights to the bottom line motive, through appropriate policy choices, including tax incentives and disincentives in national frameworks,

as well as impacting the behaviour of FMPs when they market products to their clients, or decide on what business ventures to fund. An example of how to build in incentives for FMPs can be linking prudential requirements to ESG criteria, including an assessment of their business and what they fund against an ESG compliant standard. We also need to acknowledge that there is a reason why SMEs are more reluctant to access the capital market in the EU than in the US.

A new concept is needed for SMEs – a market that would be adapted to their needs and free of the many regulatory burdens that are appropriate for larger, more mature firms, while also incentivising the take-up of ESG criteria with the profitability goal in mind. The benefits of the sustainability agenda need to convince SMEs, or the future of the project remains uncertain. ●