WHITE PAPER

How EU Financial Institutions can Prepare for CSRD/ESRS

(adjusted based on updated *European Commission's draft Delegated Act on June 9th*)

Updated June 2023
By Stefan Bochtler, Lorenzo Fantini, Natalie Ernst and Jannik Leiendecker

How EU Financial Institutions can Prepare for CSRD/ESRS

CSRD and ESRS are the gold standard for ESG regulations, which are likely going to result in the harmonization of ESG reporting in Europe. With more than 100 ESG KPIs demanded from the regulator, the level of complexity and volume of ESG-related data requirements will significantly increase for financial institutions.

The regulatory ESG landscape has advanced rapidly since the Paris Agreement in 2015, with an inevitable impact on financial institutions. For example, in one ambitious regulatory initiative on sustainability, the ECB published a guide for banks on climate-related and environmental risks. The EU is now aiming to accelerate regulatory momentum by introducing obligations on disclosure, which involve mandatory reporting standards and external assurance in order to create transparency and harmonization of sustainability data.

Both the Corporate Sustainability Reporting Directive (CSRD) and the European Sustainability Reporting Standards (ESRS) are driving the harmonization of sustainability data in the EU. While CSRD extends the Non-Financial Reporting Directive (NFRD), compelling significantly more companies to disclose comprehensive ESG criteria, ESRS addresses and formulates CSRD requirements for in-scope entities. Given the high level of complexity and the volume of ESG-related data requirements, these regulatory commitments will pose significant challenges for financial institutions and corporates. Indeed, CSRD/ESRS requires more than 100 ESG key performance indicators (KPIs), obliging financial institutions not only to adjust reporting processes, but also to update their ESG strategies, governance and data capabilities.

On 9th June 2023, an updated draft Delegated Act to supplement the earlier CSRD / ESRS draft was issued asking companies to report against their material topics (amendments included some KPI adjustments from mandatory to voluntary and introduction of extended phase-in periods).

Note: This document has been updated after the publication of the *European Commission's draft Delegated Act on June 9th*.

Corporate Sustainability Reporting Directive (CSRD)

- Extends and strengthens existing Non-Financial Reporting Directive (NFRD) as uniform sustainability disclosure standard
- Expands scope to include more companies than the NFRD and requires corporates to report on a wider range of sustainability-related issues
- Improves data availability on sustainability risks of companies as well as their activities' effects on the environment
- Based on the principle of "double materiality", obliging companies to report on how their business is affected by sustainability issues, and how their activities impact society and the environment
- Scope:
  - From 2024 onwards: Large entities of public interest with more than 500 FTE already subject to NFRD. First reporting in 2025
  - From 2025 onwards: Large listed and unlisted companies, which are currently not subject to NFRD. First reporting in 2026
  - From 2026 onwards: Listed small and medium-sized enterprises (SMEs) and small, non-complex credit and captive insurance undertakings. First reporting in 2027 with a postponement option to 2029
  - Non-EU companies from third countries will also become subject to the CSRD if certain criteria are met

European Sustainability Reporting Standards (ESRS)

- Developed by the European Financial Reporting Advisory Group (EFRAG)
- Builds on CSRD requirements, and can be viewed as the operational guidance for companies
- Standards aim to synchronize underlying methodologies and therefore harmonize ESG reporting while also aligning with existing standards, e.g., the Global Reporting Initiative (GRI)
- ESRS covers 12 different standards (ESRS 1-2, E1-5, S1-4, G1), including climate change, biodiversity as well as social and governance
- Draft Delegated Act published by the European Commission allows
  - more flexible and voluntary disclosure of certain data points
  - phase-in of data points after the first year's disclosure
- Applies to companies within the EU and to non-EU companies, both as defined as per the CSRD

Growing urgency to prepare for CSRD/ESRS reporting

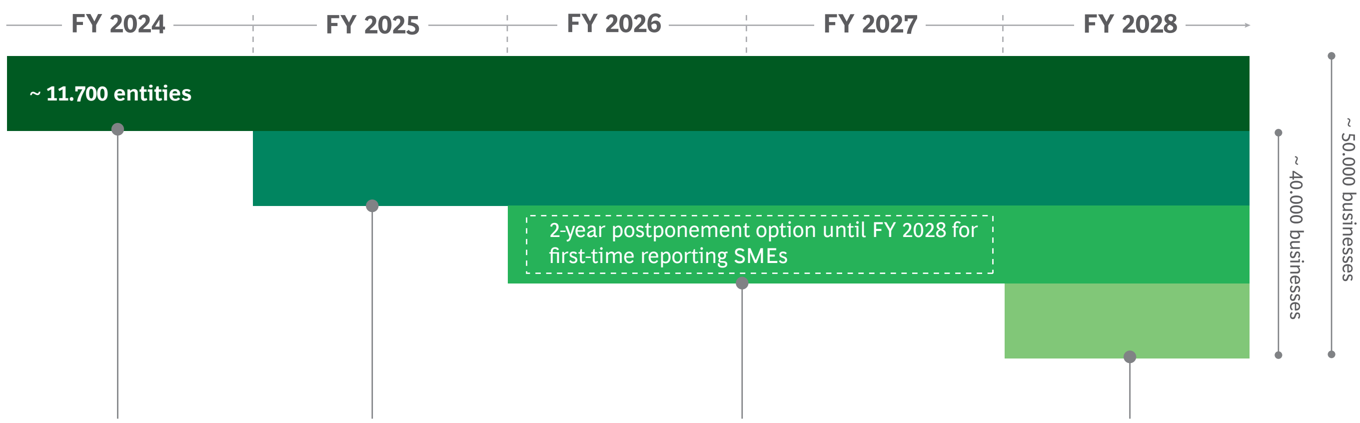
The deadline for CSRD/ESRS implementation is imminent

The deadline for the implementation of CSRD/ESRS is fast approaching, as the CSRD became effective from January 1, 2023.

CSRD and ESRS will be implemented in multiple stages – first focusing on large public-interest entities, and later moving to cover small and medium-sized entities. For large public-interest entities already subject to NFRD, the CSRD and ESRS requirements will apply from financial year 2024 onwards. For these in-scope entities, timely and accurate CSRD/ESRS reporting will be of significant strategic importance. It is vital, therefore, that such companies make immediate preparations for the 2024 requirements by devising and institutionalizing the relevant processes.

For other large entities that are currently not subject to NFRD, reporting obligations will start a year later, with data to be captured for financial year 2025 onwards and initial reports to be prepared in 2026. Starting from financial year 2026, listed SMEs will also be required to report, but with an option to opt out until financial year 2028. In addition, EFRAG is planning to develop distinct and proportional standards for SMEs in the coming years.

Exhibit 1 - CSRD/ESRS will apply progressively to entities in the EU from Financial Year (FY) 2024 onwards



Large public-interest entities (PIEs)[1]:

- Listed companies and other PIEs[1] only
- Reporting under NFRD[2]
- With > 500 FTE

Large EU undertakings:

- Listed & unlisted companies
- Meeting at least 2 criteria:
  > 250 FTE
  > €20M total assets
  > €40M net revenue

Small and medium-sized EU enterprises (SME), which are also PIEs[1]:

- Listed SMEs and other PIEs[1] only
- Meeting at least 2 criteria:
  > 50 FTE
  > €4M total assets
  > €8M net revenue

Third-country undertakings (Non-EU companies):

- > €150M net revenue in EU
- Meeting at least 1 criteria:
  EU Branch (> €40M net rev.)
  AND/OR EU subsidiary

Source: BCG.

1. Public-interest entities include listed companies, as well as banks and credit institutions, insurance companies, and other companies designated by national authorities to be of public interest.

2. Non-Financial Reporting Directive.

FY = Financial Year; CSRD = Corporate Sustainability Reporting Directive; ESRS = European Sustainability Reporting Standards.

Assumption: Not within the scope of the CSRD/ESRS are (i) unlisted EU SMEs (ii); listed micro-enterprises; (iii) companies that meet the thresholds only in one consecutive FY

CSRD/ESRS require a large amount of ESG data

The CSRD/ESRS regulations entail granular qualitative and quantitative KPIs across ten categories, covering all the dimensions of ESG – for example, climate change, pollution and biodiversity for “E”, workers in the value chain for “S”, and business conduct for “G”. The types of KPIs that financial institutions need to submit across all dimensions follow a certain pattern - including descriptions of policies, targets, action plans, transition plans and potential financial impact. The proportion of quantitative or qualitative KPIs per thematic category varies and depends on the type of information required.

The draft Delegated Act published by the European Commission includes certain measures to rationalize reporting obligations whilst retaining ambitious objectives. To apply standards effectively all undertakings may phase-in certain requirements after the first year’s disclosure, such as anticipated financial effects related to non-climate environmental issues or data-points related to own workforce. For companies with less than 750 employees further KPIs can be omitted in the first two years.

Additionally, certain disclosures will be voluntary or can be handled more flexibly. For example, biodiversity transition plans or indicators concerning “non-employees” will not be mandatory. Further data points offer flexible disclosure, like financial effects arising from sustainability risks or KPIs regarding corruption and bribery.

Exhibit 2 - Gap Analysis & Target Picture | Companies will be asked to report against material topics

	ESG topic areas from CSRD/ESRS	KPI Type: Process description	Policies	Targets[1]	Action Plans	Transition Plans	Potential financial effect	Other KPIs (*illustrative, not exhaustive*)	Quantitative KPI
E	**Climate change**	✗	✓	✓	✓	✓	✓	• Gross Scopes 1-3 GHG Emissions • GHG removals and mitigation	**18**/37
E	**Pollution**	✓	✓	✓	✓	✗	✓	• Pollution of air, water and soil	**3**/7
E	**Water & marine resources**	✓	✓	✓	✓	✗	✓	• Water consumption	**2**/6
E	**Biodiversity & ecosystems**	✗	✓	✓	✓	✓	✓	• Impact metrics related to biodiversity and ecosystems	**0**/8
E	**Resource use & circular economy change**	✓	✓	✓	✓	✗	✓	• Resource outflows • Resource inflows	**3**/7
S	**Own workforce**	✓	✓	✓	✓	✗	✗	• Collective bargaining coverage • Diversity indicators	**26**/31
S	**Workers in the value chain**	✓	✓	✓	✓	✗	✗		**1**/5
S	**Affected communities**	✓	✓	✓	✓	✗	✗		**1**/5
S	**Consumers & end-users**	✓	✓	✓	✓	✗	✗	• Channels to raise concerns	**1**/5
G	**Business conduct**	✗	✓	✗	✗	✗	✗	• Anti-corruption mechanisms • Political influencing activities	**7**/12

 # Quantitative KPI / Total

✓ KPI required ✗ No KPI required

Source: BCG.

Note: This has been updated to facilitate cohesion and interoperationality between international standards in line with the Delegated Act cohesion ammendment.

1. The overview shown represents a rough classification - within the category, individual KPIs can vary per thematic block.

2. In the first step, publish those targets that insurance companies have already set. Increasing expectation that targets will also be set on the “target KPIs” - therefore, further expansion stages should be taken into consideration.

ESRS = European Sustainability Reporting Standards.

Assurance of CSRD/ESRS requirements must be effectively managed

With ESG requirements expanding rapidly, financial institutions should be aware of the consequences if they do not comply. These could potentially include fines, legal consequences, or damage to reputation and business relationships.

The CSRD is a much broader directive than its predecessor, NFRD. It has introduced an audit requirement, for which financial institutions need to prepare accordingly. This statutory audit requirement applies for three main reasons: 1) More companies are affected by CSRD; 2) the CSRD/ESRS regulations demand additional information; and 3) CSRD/ESRS requires limited assurance on sustainability information, although the end goal is to move to reasonable assurance in the longer term.

The challenge of implementation for financial institutions

One of the main challenges for financial institutions is that CSRD/ESRS requirements have been written with corporates in mind. Bank-specific standards were expected to be published before the end of 2024, but recently EFRAG has decided to postpone sector-specific standards and now plans to develop these under a "modified timetable". It is anticipated that bank-specific standards will call for further KPIs, and potentially some additional guidance on existing standards. That said, the current interpretation of standards is not likely to change significantly. As a result, financial institutions should start preparing their data-capturing capabilities and develop their initial report according to certain hypotheses.

Key hypotheses for banks to consider when setting out their CSRD/ESRS reporting objectives

Financial institutions need to integrate CSRD/ESRS requirements into their existing operations. This involves not only strategy and steering, but also governance, risk management as well as quantification and enablers. We have identified five critical hypotheses that financial institutions will need to consider when incorporating CSRD/ESRS reporting into their target operating model:

1. **Target setting: Financial Institutions will need to disclose existing target KPIs – increasing ESG transparency will drive FIs to set new targets**

   Current targets of financial institutions focus almost exclusively on the climate change component. CSRD/ESRS brings an increasing regulatory expectation on financial institutions to set targets beyond climate-related matters – including, for example biodiversity, pollution as well as social and governance issues. In the first step, CSRD/ESRS requires financial institutions to publish those ESG targets that have already been set without having to formulate new targets. However, with the increasing ESG momentum among other competitors in the market, it can be expected that this will lead financial institutions to formulate new ESG targets. These will need to be incorporated into strategies and processes and must be aligned to existing initiatives, such as carbon accounting.

2. Exploiting opportunities: Beyond regulatory requirements, CSRD/ESRS reporting capabilities can lead to further business opportunities

Building up reporting capabilities should not just be seen as a regulatory burden for financial institutions. The exercise can also present an opportunity if handled correctly. For example, the systematic collection and analysis of CSRD data from customers might lead to the identification and seizure of new business possibilities.

For instance, platform ecosystems can be established, in which financial institutions support clients as brokers for third-party services and actively engage in a dialogue on customer KPIs. For this purpose, innovations arising from cooperation with companies and startups should be integrated into the ecosystem. Finally, financial institutions can expand their horizons away from simply capturing data. They can become data providers and methodology champions for CSRD KPIs that focus on the customer portfolio. It is certainly true that clients expect financial institutions not just to focus on KPIs demanded by regulators, but also to engage in activities that benefit them directly.

3. Establishing governance structures: To institutionalize ESG reporting, ESG governance structures need to be critically reviewed

For the implementation of CSRD/ESRS reporting, departments across the entire organization (including group sustainability, human resources, compliance and finance) will be involved. In comparison to a fragmented and siloed approach by individual business units, views on all ESG topics from across the entire organization should be gathered. Given the increasing volume of ESG-related regulations, a suitable governance structure should be put in place to manage the organization's reporting and allow for comprehensive steering.

The governance structure would aim to identify responsibilities in the report generation process and support the interaction between various individuals and divisions, allowing for a smooth reporting process. This should be supplemented by operational IT infrastructure and constant collaboration with internal and external auditors.

4. Adopting a portfolio perspective: The role of banks as change agents goes beyond the issue of climate to encompass a bank's entire portfolio

CSRD and ESRS regulations require extended information and explanations for more than 20 KPIs, including information on activities within the value chain. For a financial institution, this would mean that the entire portfolio of a bank would be subject to the ESRS definition of a value chain (see box below).

As regulators envisage financial institutions as change agents beyond just the issue of climate change, the term "value chain" thus encompasses the entire portfolio. This line of argument is also supported by the EU taxonomy, which will require banks to calculate a green asset ratio according to a wide range of sustainability targets, including biodiversity, pollution and circular economy. Moreover, from the perspective of the EU Corporate Due Diligence Directive, human rights issues must also be assessed along the entire value chain, and this also applies to financial institutions.

ESRS does allow for a phased approach for some value-chain KPIs (beyond carbon accounting) of a maximum of three years. However, the data, methodology and calculations required for topics such as biodiversity and pollution will be just as complex as they have been for carbon accounting. Financial institutions must therefore get to grips with these issues early on in the CSRD/ESRS implementation.

ESRS Value Chain Definition: “The value chain is the full range of activities, resources and relationships related to the company’s business model(s) and the external environment in which it operates. A value chain comprises the activities, resources, and relationships that the company uses and relies on to produce its products or services from conception through delivery, consumption, and end of life.”

5. **Expanding data capabilities: To meet CSRD/ESRS requirements, companies must dramatically boost their data capabilities**

   To fulfill CSRD/ESRS requirements, current capabilities (including methodology, data and systems) need to be significantly upgraded in order to create a holistic ESG perspective. The initial starting point here would be to define a target ESG reporting picture that responds to additional reporting obligations when they arise. Companies need to expand capabilities because each KPI comprises various data points that reside in different systems across the organization. To manage the increasing complexity of data points, in particular those that cut across internal organizational boundaries, the introduction of tool-based solutions to support ESG reporting processes should be considered.

Practical implementation: our recommended approach

To assess CSRD/ESRS readiness and build a future ESG reporting target picture, we suggest a three-step approach, which involves carrying out a gap analysis, conducting a materiality assessment and defining an implementation roadmap for execution.

Step 1: Gap analysis to assess CSRD/ESRS readiness and develop a target picture

To assess CSRD/ESRS readiness and derive a clear view of the maturity of financial institutions’ ESG reporting, the latest sustainability report – if available – should be examined against upcoming CSRD/ESRS requirements. The aim of this analysis is to identify reporting gaps and to determine whether the current availability of data and the system landscape meet future CSRD/ESRS reporting requirements. For a first outside-in assessment, KPIs can be systematically analyzed from an operations perspective and then cross-checked against published sustainability reports.

After the initial gap assessment, financial institutions should develop concrete measures to resolve potential issues. This would include devising internal and external system solutions to support ESG reporting. To gauge readiness, the company should design a future governance model based on the ESG target picture, and also define an implementation roadmap.

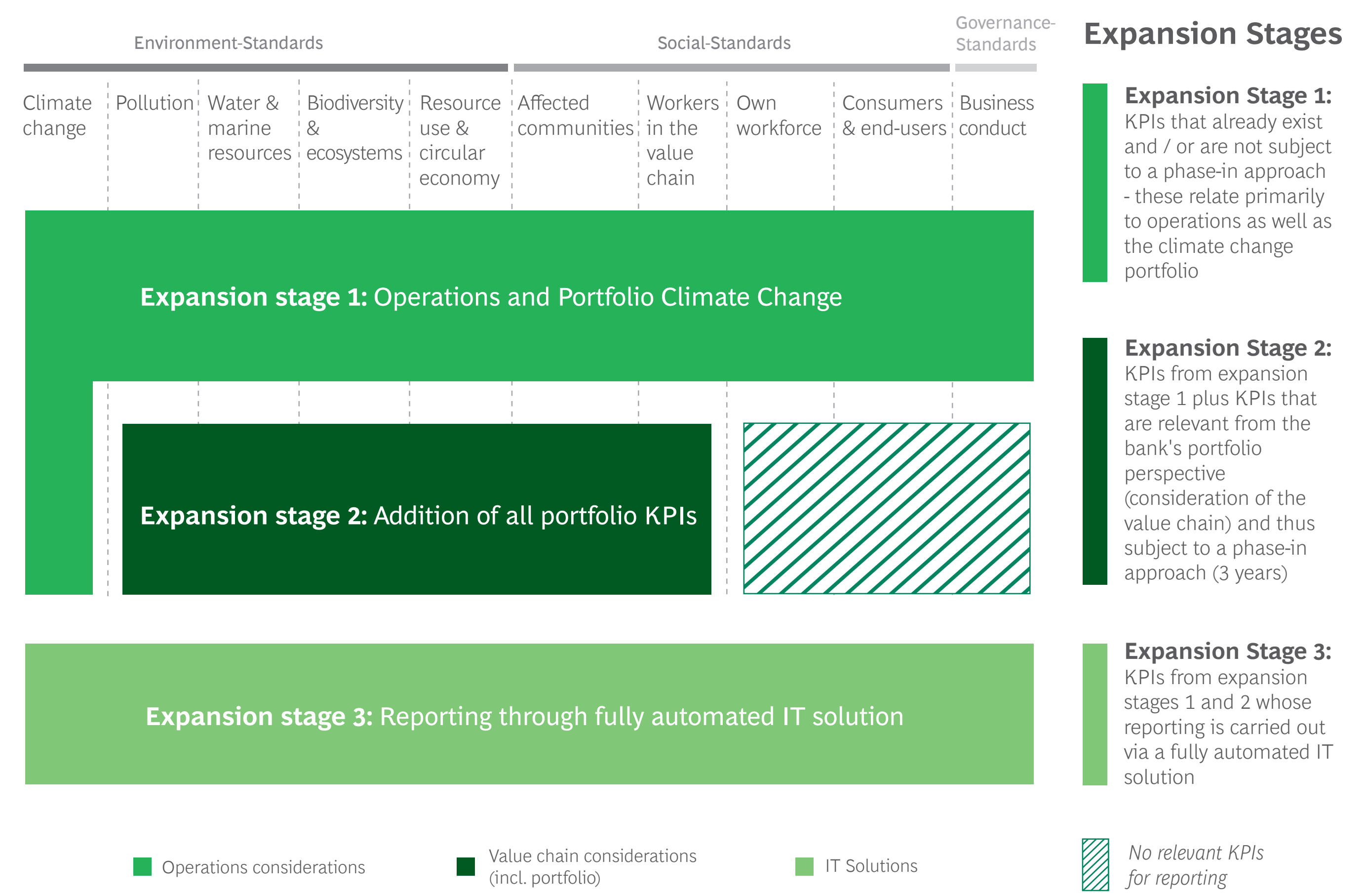
Step 2: Materiality assessment: Financial institutions are obliged to conduct a double materiality assessment for all KPIs, which can also be leveraged as a tool to capture stakeholders’ perspectives on ESG. Furthermore, such an assessment can inform ESG strategies and indicate where future investment may be required. Introduced by CSRD, the double materiality assessment involves reporting from two angles: how ESG-related issues affect the company; and how the company’s own actions affect people and the environment.

BCG has developed a proven approach to effectively conduct a double materiality assessment within financial institutions. First, a shortlist of relevant ESG themes, based on EFRAG standards, market practices and distinctive characteristics of the client, should be drawn up. Second, the materiality surveys can be prepared, which includes a weighting logic for the materiality scoring tool and pre-engagement with stakeholders. Third, the materiality survey and additional key stakeholder interviews should be carried out for a preliminary framing of the materiality matrix. The last step of the assessment is to refine material by clustering ESG themes and then produce the final materiality report. The assessment findings should inform the implementation roadmap for the coming years.

Step 3: Implementation based on a previously defined roadmap and matrix project organization

Due to the ambiguity in regulatory guidance and the potential updates to follow, we recommend a phased implementation approach. The first phase of the implementation focuses on those KPIs that already exist and are mandatory for the initial CSRD/ESRS reporting period. Currently, these KPIs relate primarily to the financial institution's operations as well as the climate change portfolio. Adding to this, the second stage considers the value chain, covering KPIs relevant to the financial institution's portfolio, and is thus subject to the three-year phase-in period permitted by CSRD/ESRS. While the first and second phases will be administered manually to make sure that reporting is completed promptly, the final stage should involve implementing an automated solution to increase the efficiency of the reporting process.

Exhibit 3 - Phased implementation approach for full KPI coverage



Note: To apply standards effectively all undertakings can phase-in certain requirements after the first year's disclosure such as anticipated financial effects related to non-climate environmental issues or datapoints related to own workforce. For companies with less than 750 employees, further KPIs can be omitted in the first two years.

Moreover, financial institutions should continually reassess the target operating model against the ESG reporting target picture. We recommend that financial institutions characterized by complex organizational structures (for example, with multiple reporting subsidiaries) establish a matrix project organization that includes a strong central team and content owners. This matrix project organization would, for example, handle target setting and data computation in a consistent way across the group. An ESG committee should also be set up in financial institutions as the ultimate decision-making body and highest escalation authority for ESG issues. The committee should be supported by a coordination group that provides updates on project progress, as well as by a CSRD/ESRS steering committee that has the mandate to make rapid decisions based on project needs and execute any relevant iterations.

Conclusion: Anticipating requirements

Given the complexity of the CSRD/ESRS regulations, and ambiguity of individual value-chain KPIs and disclosure requirements, financial institutions should start thinking about ESG reporting readiness now.

It is all the more important, therefore, for financial institutions to anticipate additional requirements and commitments well in advance so that they are well prepared for any eventuality. To respond to the upcoming regulatory changes, companies will need to incorporate new ESG reporting requirements in their approach. In this way, they can gradually develop their KPI reporting, building it up continuously. A new or expanded ESG governance structure within the organization would ensure successful project management and prepare the ground for the initial report.

About the Authors

Stefan Bochtler is a Managing Director & Partner in our BCG Office in Munich.

Lorenzo Fantini is a Managing Director & Partner in our BCG Office in Milan.

Natalie Ernst is a Partner in our BCG Office in Frankfurt.

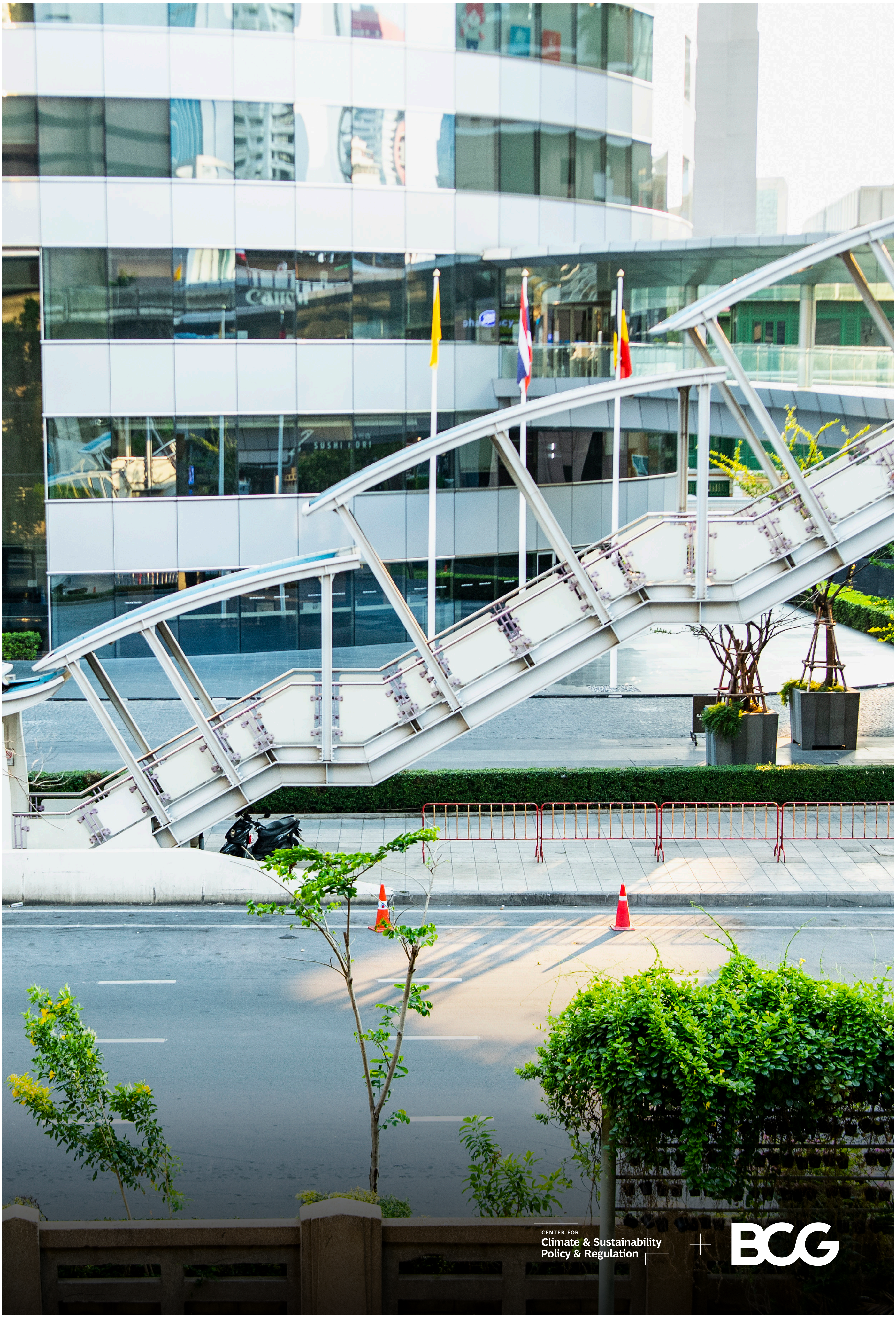
Jannik Leiendecker is a Partner & Associate Director in our BCG Office in Munich.

Acknowledgments

The authors would like to thank Anne Kleppe, Jasmin Huck, Kristopher Weber, Anand Kumar, Maria Cava and Julie Foucault for their contribution to this white paper.

For Further Contact

If you would like to discuss this report, please contact the authors.


CENTER FOR
Climate & Sustainability
Policy & Regulation
BCG