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## Article

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## GOOD PRACTICES ON ESG REPORTING IN THE CONTEXT OF THE EUROPEAN GREEN DEAL

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### Abstract

The European Green Deal proposes a series of measures to the EU Member States in order to adopt policies on how to use and produce green energy, support new clean technologies, and reduce noise, air and water pollution. The target referring to reducing emissions by at least 50% by 2030 has already strongly impacted Europe on social, economic and environmental levels, as well as the business sector. This study begins by highlighting the importance of complying with social, environmental, and governance reporting of large companies and the banking sector alike in the context of adopting the European Green Deal. Furthermore, we continue by showcasing how the new disclosure requirements and recommendations have been adapted and translated into non-financial ESG reporting (environmental, social, and governance impact of economic activity). Finally, we present a series of best practices in this area. As the present study has revealed the need to improve ESG reporting, good-practice recommendations were identified and formulated.

**Keywords:** best practices, social factors, environmental factors, governance, ESG non-financial reporting.

**JEL Classification:** G20, G30, G38, F64.

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## Introduction

The European Green Deal has identified a number of priority areas where joint action by all stakeholders is absolutely necessary; yet, the business environment plays the major role. By signing the Green Deal, the European Commission (2021) established targets such as:

- access to secure and sustainable energy;
- placing consumers in the center of the energy system;
- conservation of natural resources;
- ensuring a blue economy;
- protection and promotion of public health;
- providing affordable food.

Economic activities within the European Union involve both opportunities and constraints. Common EU policies impact business and entrepreneurship both within the common market and in Member States' markets (Dima, 2018). With the recently launched Green Deal, Europe aims to be the first climate-neutral continent, becoming a modern and resource-efficient economy.

According to Nancu and Mihai (2021), companies represent a collaboration between two or more persons who agree to share certain assets in order to carry out a specific activity together and to share the benefits arising from this collaboration. However, this collaboration should also generate benefits for the environment and society. The Organisation for Economic Cooperation and Development (OECD) estimates that in order to have a 66% chance of limiting the increase of the average temperature on Earth to below 2°C, additional investments are needed in the next 10 years, and they are estimated to be around \$630 billion per year. To comply with this goal, Romania has set the objective of improving the investment standards established in the Investment Declaration and in the Principles of Corporate Governance (Dinu, 2022).

In the context of sustainability of all economic sectors, environmental issues have gained traction, not only as a social cause, but also as an inherent part of business practices. The use of green energy is central to these environmental concerns, particularly in the financing of green assets of companies, where smart energy practices are embedded in social responsibility.

In this volatile, uncertain, complex, and ambiguous world, companies frequently face problems in decision making when it comes to required resources and their allocation in order for them to operate and achieve desired outcomes, performance, and goals (Minciu, Berar and Dobrea, 2020).

Romanian companies and the banking sector alike have already implemented a series of measures to support and encourage the purchase of green assets. These actions are primarily aimed at reducing the negative consequences of businesses on the European climate, as established by the European Green Deal. As these actions are resource-intensive, they require substantial financial efforts from the Romanian private sector. The involvement of the government extends to the introduction of programmes to: renew energy-inefficient equipment, recycle waste, and digitise public services. Concomitantly with the government's

work, a number of companies have already adapted their policies by including measures to stimulate carbon and waste reduction in conjunction with the protection of public health. In addition, large Romanian firms, including the banking sector, engaged in raising awareness, especially among employees, about the importance of human action on the environment. At the same time, many Romanian companies have also accessed government programmes in order to purchase energy-efficient equipment, and they have also taken measures to increase food safety.

### 1. Literature review

As early as 2014, through the Directive on the reporting of non-financial information (Directive 2014/95/EU ), the obligation of non-financial reporting was established for companies with more than 500 employees, in addition to the usual financial reporting (European Parliament, Council of the European Union, 2014). The European Directive was transposed into Romanian law by Orders of the Minister of Public Finance (OMFP 1802/2014 and OMFP 2844/2016). This type of reporting aims to assess the impact of economic activity on the environmental, social, and governance issues. Moreover, firms were required to present information detailing the efforts to respect human rights, eradicate corruption, and bribery together with ensuring diversity in the company boards (in this regard, the requirement was to include people of all ages, gender, professional, and educational backgrounds within all company structures).

Subsequently, following the adoption of the European Green Deal in 2019, a new demand has emerged for uniform criteria to facilitate non-financial reporting, and, as such, the following issues were raised:

- Which economic activities can be considered environmentally sustainable?
- Which are the criteria that ensure: increased transparency; consistency in classifying activities as sustainable; reduced risk of environmental misinformation?

In order to clarify the answers to these questions, the European Commission elaborated Regulation (EU) 2020/852 (European Commission, 2020), which sets out six targets for non-financial reporting, as follows:

- climate change mitigation;
- adapting to climate change;
- sustainable water use;
- protection of waters and marine resources;
- transition to the circular economy;
- prevention and control of pollution and protection and restoration of biodiversity and ecosystems.

Therefore, all economic activities must be analysed in light of these six objectives in order to be recognized as sustainable. Consequently, turnover and total expenditure are analysed for non-financial reporting purposes, next to the value of tangible and intangible assets which are also analysed in terms of the eligible activities under the taxonomy. These analyses are

necessary to determine the percentage of activities considered sustainable compared to the total financial items. To this end, it is necessary to: identify those activities of companies that fall within those mentioned in the taxonomy (certain CANE (Classification of Activities in the National Economy) codes are specified) and verify their eligibility. Moreover, it is necessary to determine whether these activities contribute significantly to one of the environmental objectives. It is rather evident that the impact of these activities over environmental objectives must also be analysed in parallel, potential damages must be minimised, and last but not least, all these processes must be carried out in accordance with minimum safeguards, i.e., respecting human rights.

For determining the technical criteria that must be considered when reporting, companies that have set climate change mitigation among its environmental objectives must assess the impact of their activities through the lens of EU Regulation 2020/852 (European Commission, 2020). This assessment requires determining the contribution that the company has made to stabilising greenhouse gas emissions (European Commission, 2020). This environmental objective must be interpreted in accordance with relevant EU law, including Directive 2009/31/EC of the European Parliament and of the Council.

The objective of the European Green Deal regarding the reduction of emissions, at least by half, requires a reorientation of company practices (including those in Romania) to minimise the impact of its activity on the environment (European Commission, 2019). In this context, the publication of non-financial reports has become imperative. The ESG factors included in these reports refer to: environmental factors (E), social factors (S), and governance (G).

Understanding the multiple ways in which environmental, social, and governmental factors can create value is particularly important (Henisz, Koller and Nuttal, 2019). Adopting environmental practices usually leads to good environmental performance (Melnik, Sroufe and Calantone, 2003; Annandale, Morrison-Saunders and Bouma, 2004; Zhu and Sarkis, 2004). However, good levels of environmental performance can be achieved based on the implementation of different types of environmental practices, practices that do not always have the same effects on environmental performance (Henri and Journeault, 2008).

Klassen and Whybark (1999) indicate that proactive environmental pollution technologies exert a positive influence on the economic activity, while end-of-pipe technologies do not. More recent studies have shown that high financial performance of a company is positively correlated with high environmental performance only if environmental management has a proactive pollution orientation (Wagner, 2005; Mihalca et al., 2021).

Social responsibility, representing the degree of compliance with legal, economic, ethical, and philanthropic responsibilities to society, has become highly relevant in achieving economic advantages. Cho, Chung and Young (2019) argue for a positive correlation between corporate social responsibility and firm performance using financial, accounting, and market indicators. It is worth noting that the sector of activity greatly influences the analysis of the correlation between social responsibility and financial performance. The impact of social responsibility is greater for firms in the service sector than for those in manufacturing industries (Cho, Chung and Young, 2019; Amoah et al., 2021). The social role of firms (especially large firms) is greater as public perception is rapidly influenced by the decisions of the companies. In their research, Fontes, Moreira and Carlos (2021) show that green purchase behaviour is heavily impacted by both purchase intention and environmental activity. From a cost perspective, some of the research in the field of social

responsibility shows that, in general, corporate social actions lead to higher profits. However, a small number of studies show the opposite, namely that social responsibility generates costs that outweigh profits (McWilliams and Siegel, 2001; Busu, Vargas and Gherasim, 2020).

Corporate governance refers to agency theory (Roy, 2016; Gheorghiu, Spătariu and Georgescu, 2017) and reflects the influences that management exerts when making financial decisions. From an investor perspective, corporate governance is of great interest because it provides information on the accuracy, transparency, and sustainability of financial reporting and auditing. Sustainable reporting has the merit of reflecting organisational change and development beyond financial issues (Lozano, Nummert and Ceulemans, 2016). In this context, the motivation to report and weigh results through economic, social, sustainable, and environmental dimensions, driven by numerous factors, has become crucial (Engert et al., 2016). The actual need for managerial care and the correct use of control levers that precede financial reporting and address non-compliance during the decision-making process has also been demonstrated. (Munteanu et al., 2021; Lehene, 2021).

Therefore, ESG reporting is necessary in the context of the European Green Deal. Although the practice of ESG reporting has grown in importance in recent years, there is still a considerable gap between the information contained in ESG reporting and the supply of information. This gap is caused by factors such as different ESG reporting standards and frameworks, different reporting regimes (each country has its own reporting regulations), and high costs related to data collection and reporting. These factors can hamper efforts to provide investors with better quality data in order to make informed decisions. This is why many companies seek advice in this area to develop and incorporate balanced ESG strategies into their policies.

## 2. ESG reporting in the banking sector

Environmental, social and governance (ESG) factors help measure the sustainability and societal impact of businesses that are financed by banks. Banks are therefore the bridge between investors and capital seekers, so ESG reporting is a vital tool for market discipline, allowing stakeholders to assess the environmental risks of banks and their sustainable financing. As a result of climate change, banks become exposed to physical and transition risk in which potential investors have a legitimate interest (Dima and Vasilache, 2016). They are also particularly interested in banks' strategies for financing the transition to a zero-carbon economy, and in this sense, the European Banking Authority (EBA) requires banks to publish information on:

- Climate risks: how climate change can exacerbate other risks on banks' balance sheets, whether it is a carbon-intensive risk, or a risk related to lending activity;
- Mitigation measures: which mitigation measures have been taken by banks in order to address these risks, including financing activities that reduce carbon emissions;
- Green asset ratio and banking book taxonomy alignment ratio (BTAR): to highlight how institutions fund activities that are in line with the objectives of climate change mitigation and adaptation based on taxonomy of green activities.

In addition, the European Banking Authority requires banks to describe ESG measures on strategies, governance, and risk management arrangements in relation to ESG risks.

According to a study conducted by the international audit and business advisory firm Mazars, most of the assessed banks have shown interest in sustainability and have already made significant progress in adopting relevant policies (Buzgure, 2022). For example, out of a total of 37 banks included in the study (located in Africa, the Americas, Asia-Pacific, and Europe), 62% have already integrated ESG factors and climate risks into their internal risk management policy, achieving higher scores related to ESG reporting activity in 2021 than in the previous year.

However, the report shows that there are many areas for improvement in ESG reporting. For example, governance and reporting scores have been declining, since the results for 2020 show that 82% of the world's largest banks aligned transparency disclosure with ESG reporting, while in 2021 only 77% of them did so. In terms of adopted measures to ensure the transition to sustainable governance, 60% of the banks included in the study had implemented such measures in 2021, significantly fewer than in 2020, when 74% of them had taken such measures. The best results were those of English and French banks, which registered the highest ESG risk management scores in all countries in which they operate.

Moreover, the latest report published by the European Central Bank (ECB) highlighted that none of the 112 banks included in the report complies with the ECB's requirements for the inclusion of key information in ESG reporting. The ECB has, therefore, announced that it will ask central banks to impose strict regulatory requirements on this type of reporting, as the non-financial information reported by banks is insufficient to meet the ECB's expectations in this regard (European Central Bank, 2022).

Regulation (EU) 2021/2178 defines a green asset ratio (GAR) for institutional disclosure of information related to the taxonomy alignment level of exposures. The green asset ratio is therefore used as part of a broader set of tools for assessing banks. This new reporting requirement aims to determine which banking institutions allocate their resources to green finance. The definition of the green asset ratio is largely based on the opinion of the European Banking Authority issued on the 1<sup>st</sup> of March 2021 and the proposal on the introduction of the green asset ratio (final draft of 24 January 2022 implementing technical standards on prudential ESG risk disclosures under Article 449a CRR, EBA/ITS/2022/01) (European Commission, 2021).

Following the call for advice from the European Commission, the European Banking Authority has established key performance indicators (KPI) and related methodology for information disclosure addressed to credit and investment institutions. This methodology is useful for determining the extent to which particular activities qualify as environmentally sustainable according to the EU taxonomy. Among these, the Authority has highlighted the importance of the green asset ratio, as a key means to understanding how institutions finance sustainable activities and meet the objectives of the Paris Agreement.

In developing this framework, the European Banking Authority has used the recommendations of existing initiatives, such as those of the Task Force on Climate-related Financial Disclosures (TCFD) of the Financial Stability Board (FSB), but has gone further by defining mandatory templates, tables, and guidelines to ensure greater consistency, comparability, and meaningfulness of the disclosures done by institutions. According to the study conducted by Mazars, only two of the top ten banks present within the Romanian banking sector (ranked by assets) have published a local sustainability report, the rest have published such a report in their home country. Half of the banks included in the study have

adapted their products to current requirements, so they offer green credits to firms and individuals with better lending terms. However, the conclusion is that none of the ten Romanian banks included in the study delivers reports in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

The main indicator to be reported is therefore the green asset ratio, which identifies the assets that finance environmentally sustainable activities according to the EU taxonomy, such as those that are in line with the European objectives of the European Green Deal and the Paris Agreement. Information on the green asset ratio is complemented by other key indicators that provide information on the taxonomy alignment of the services of institutions, other than lending and investment. The recommendations of the European Banking Authority on non-financial reporting for credit institutions are summarised in table no. 1.

The green asset ratio is seen as a useful indicator to help investors make comparisons and better direct their capital toward those institutions with better green financing performance. The introduction of GAR also directs policy makers and helps them better understand where the capital gaps are in the Romanian banking sector. Moreover, this rate helps shape policy guidelines, which could lead to banks around the world facing more pressure from governments to finance certain sectors, respectively, the greener ones.

**Table no. 1. Indicators recommended to be included in the non-financial reporting of credit institutions according to Art.8 Taxonomy**

1	Qualitative information on environmental risk
2	Qualitative information on social risk
3	Qualitative information on governance risk
4	Climate change transition risk: Credit quality of exposures by sector, emissions and residual maturity
5	Climate change transition risk: loans secured by real estate – Energy efficiency of collateral
6	Climate change transition risk: Alignment parameters
7	Climate change transition risk: Exposures to the top 20 carbon-intensive firms
8	Physical risk related to climate change: Exposures subject to physical risk
9	Summary of GAR key performance indicators
10	Mitigation measures: Assets for the calculation of RBM

*Source: European Banking Authority, 2021*

On the other hand, there are also several risks that arise from introducing GAR. Although GAR is useful for assessing the sustainable commitments of banks, its dependence on the EU taxonomy affects reported data, so the ratio will not be able to fully reflect the sustainable commitments made by banks. Also, this rate is not sensitive enough to capture, for example, transitional financing. Another possible risk generated by GAR is the risk of regulatory arbitrage, which can occur when assets that are not considered green are transferred by banks to friendlier jurisdictions in order to improve scores. This is because GAR is expected to ~~it is anticipated that GAR could~~ have a direct effect on the share price of a financial institution.

Moreover, questions have been raised about the usefulness of this indicator and the fact that it may not prove to be strong enough to generate significant changes within banks. This is because the aim of the green asset ratio is limited, both in terms of jurisdiction and assets,



but also in terms of the binary nature of the EU taxonomy and the inability of this new ratio to encompass transitional financing costs, as well as the lack of available data.

Therefore, in theory, GAR is intended to provide investors and regulators with information that allows them to determine how green a bank's balance sheet is and replace the missing information that many financial institutions use to claim their green activity.

The European Banking Authority's Credit Risk Report for the financial year 2021 (EBA/REP/2022/04) estimated an average green asset ratio of 7.9% for a sample of 29 banks in ten EU Member States aligned with the EU taxonomy. By the end of 2022, European banks will be required to disclose information reflecting the proportion of assets within banking books that are aligned with the EU taxonomy. The ultimate test of this ratio's effectiveness is its ability to lead to major behavioural changes in the banking sector. Consequently, it will lead to growing capital allocations for those economic activities that are aligned with the EU taxonomy.

### **3. Best practices regarding the implementation of non-financial ESG reporting**

Under the conditions imposed by the European Green Deal, the need to adapt company policies related to environmental, social, and governance issues has emerged. The role of the banking sector is of great importance, as banks are able to improve lending to energy-efficient sectors.

At national level, the Romanian banking sector has quickly adapted to the new requirements, with a number of banks developing and publishing non-financial statements and sustainability reports, and some of these banks are presented next.

*Alpha Bank Romania* is the first bank in Romania to become a member of the Energy Efficient Mortgage Certification Scheme and to set up an ESG department to ensure the integration of ESG factors into the governance policies of the bank. Furthermore, in 2021, Alpha Bank Romania conducted a process to identify and represent the most significant issues for its responsible operation, involving all stakeholders. In terms of social responsibility, Alpha Bank was involved in:

- funding the *Study on Population Ageing* carried out by CFA Romania and the *Financial Education Programme for Children* carried out by the Association for the Promotion of Performance in Education (as sponsor);
- supporting the *Open Banking Hackathon Event* (as a partner), a competition aimed at the fintech sector, focused on building value-creating applications, in addition to the already tested Open Banking data aggregation platform provided by Finqware;
- raising awareness of the importance of cybersecurity and GDPR through a social media campaign.

*BCR* is another Romanian bank that has implemented various measures and conducted non-financial ESG reporting, aiming at efficient use of electricity, fuel, and water. In fact, BCR was the first Romanian bank to publish an extensive sustainability report in line with international standards in the field of social responsibility. In order to raise awareness of ESG factors, BCR launched ECO BCR, a project aimed at raising environmental awareness among employees. BCR's initiatives to highlight the importance of ESG in banking also included

replacing neon signs with LED signs, paper recycling programs, as well as reducing the amount of paper used, engaging in employee volunteering and supporting financial education for students through the *My Finance* program, in partnership with Junior Achievement Romania. BCR Group is currently active in the social sector through *BCR Social Finance*, whose activities include supporting and creating new jobs by financing entrepreneurs in urban and rural areas, supporting civil society and supporting education by financing institutions' educational and training services.

Regarding non-banking companies, *IKEA* is one of the companies in the Romanian home and outdoor products market that published its first non-financial statement at the end of 2020. Within the issues of interest to all stakeholders *IKEA* includes circular economy, community engagement, customer deliveries, diversity and inclusion, greenhouse gas emissions and air pollution, human rights, public policy and compliance with legal requirements, supplier and employee welfare, sustainable and responsible sourcing of sourced materials and customer services, water consumption/quality management.

Another large company that has adapted its policies to the new reporting requirements is *Siemens*. Thus, the Dow Jones Sustainability Index (DJSI) published in November 2021 ranked *Siemens* as the most sustainable company in its industry, confirming that *Siemens AG* is on the right track for sustainable ESG reporting (*Siemens Sustainability Report, 2021*). As a result of the Carbon Disclosure Project, *Siemens'* work was highlighted as reducing climate change, leading to its inclusion on the annual 'A List' of the best companies promoting decarbonisation around the world. Furthermore, in the 2019 list of the Most Sustainable Companies in Industry, *Siemens* is ranked number one, and in 2021, for the fourth year in a row, *Fortune* magazine awarded *Siemens* the title of the most admired company in its industry.

As a result of the various measures implemented by Romanian banks, a number of *best practices* on ESG non-financial reporting have emerged that help users to find, recognise and compare information, always taking into account materiality and ownership provisions:

- the inclusion of a detailed and proper table of contents that follows a standard format at the beginning of ESG reports;
- a clear reporting structure;
- templates and tables that follow a consistent naming convention and are labelled in accordance with applicable standards;
- inclusion of tables and explanations on data reconciliation between different models;
- presentation of qualitative information in an organised and comprehensive way, despite the flexible nature of this information;
- meaningful explanations of the quantitative data provided in the accompanying documents;
- detailed explanations of the quantitative data presented within the documents accompanying the models submitted;
- quantitative templates in editable format (Excel);

- quantitative templates with more than the minimum information required to provide meaningful disclosure;
- inclusion of qualitative information on environmental risks or the impact of ESG risks on credit risk and/or operational and reputational risks.

Finally, we consider it appropriate to formulate some of the best practices that we believe are of interest and, why not, should be followed by banks to improve their ESG reporting and risk assessment of ESG factors. These best practices concern:

- *Assigning formal responsibilities related to sustainability issues to the board of directors and top management.* These responsibilities should include specific processes for monitoring how these issues are assessed;
- *Setting environmental targets for economic activities.* These targets should mainly aim at *financing zero net emissions for businesses or projects*, in line with the targets proposed by the Paris Agreement;
- *Implementing clear and diverse methods for assessing the bank's exposure to climate change risk.* The use of stress tests and scenario analysis is necessary for this purpose, and the data used to make these assessments must be sufficient to determine the risk of climate change. This type of risk should be reflected both in terms of credit risk (proportion of green loans) and market risk;
- *Implementing sustainability reporting standards in line with already established environmental targets.* These standards should be developed in such a way that they are fully consistent with the recommendations of the Task Force on Climate Change Reporting (TCFD).

## Conclusions

The context imposed by the European Green Deal created the conditions for the need for concrete measures to be taken by European companies, including credit institutions, in order to ensure a neutral climate in the future. Non-financial ESG reporting has become a mandatory requirement.

Companies in all sectors of the Romanian economy, including banks, have already adapted their strategies and policies in this regard. However, both in Romania and Europe there are many aspects that need to be improved. The experience of the past years on sustainability of economic activities, as well as regulations of new reporting requirements, will certainly favour the transition to a green, sustainable economy.

We believe that government authorities should be the first to get involved in developing stricter legislation, imposing concrete measures to be taken by companies to reduce gas emissions. Central banks are also an important part of this endeavour, as they have the legitimacy to impose restrictions on credit exposure to industries with high levels of pollution and emissions. Simultaneously, central banks can allow higher credit exposure to green industries, in order to reduce the negative environmental effects of industrialisation. However, it is necessary for all EU Member States to adapt their legislation and to reach a consensus so that the effect is rapid and generates benefits for the entire European climate.

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