

# ESG compliance

Facing new challenges head-on  
with innovative solutions  
December 2024



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# ESG topics are taking center stage in politics, business and society

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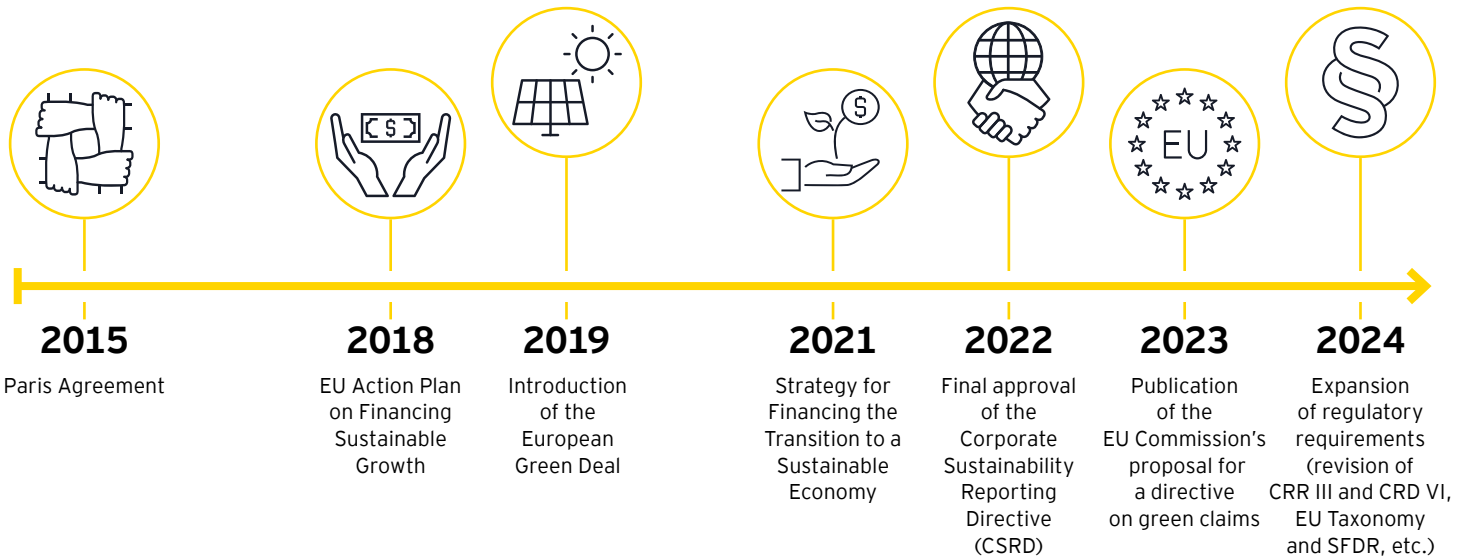
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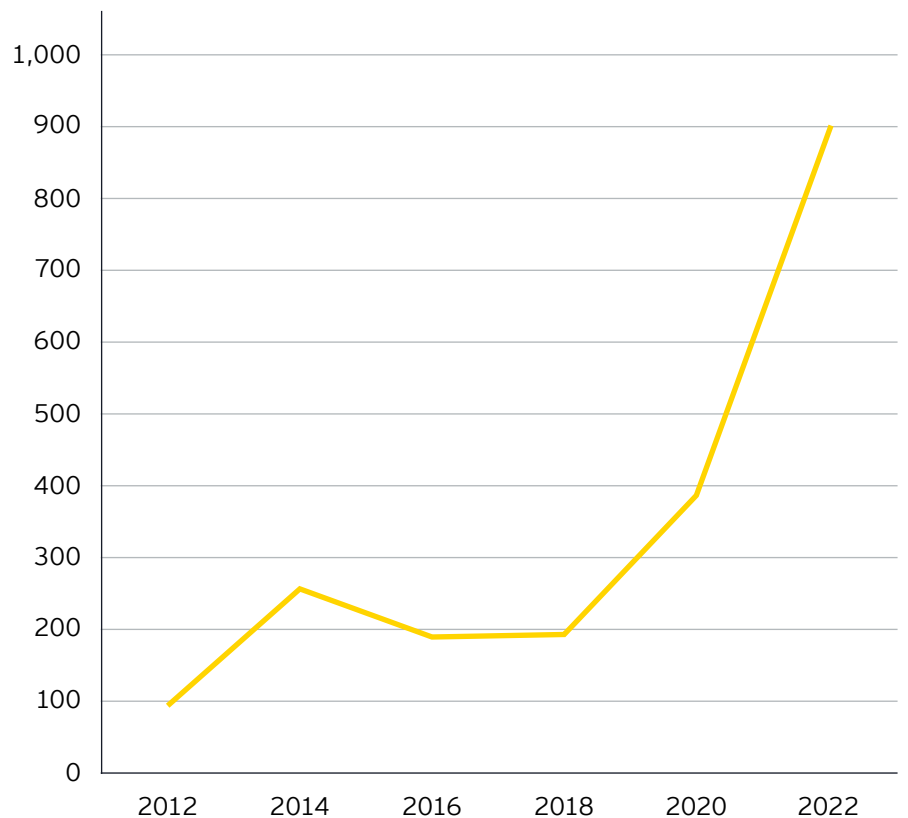
In 2015, the Paris Agreement, with its ambitious 1.5 degree target, spurred a shift in global climate policies and put the term ESG (environmental, social, governance), first coined in 2004, firmly on the agenda of many companies. The EU's Action Plan on Financing Sustainable Growth was subsequently published in 2018, setting the regulatory framework to enhance ESG awareness. This was followed a few years later by legislation such as the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR). The Corporate Sustainability Reporting Directive (CSRD) entered into force as of 1 January 2024, and 2024 is also the first year in which full reporting (on all six environmental objectives) of the EU Taxonomy Regulation is required in order to demonstrate Taxonomy alignment.



One of the objectives of the regulatory initiatives is to help ensure EU-wide standards for reporting and labeling of sustainable finance products. But banks, asset managers and others are increasingly responding to the expectations of stakeholders and customers by making voluntary ESG commitments that go beyond the current laws. The increasing scale of sustainability regulation necessitates a firm-wide implementation strategy. Failure to adequately implement sustainability standards harbors significant risks, especially in relationships with stakeholders.

The exponential rise in greenwashing (see chart) shows that a growing number of firms are attempting to appear as sustainable as possible, despite the reputational risks involved. Establishing a comprehensive compliance structure is essential for an organization to address ESG aspects.

### Greenwashing cases



# Firms need to embed ESG into their organization's practices and governance frameworks. The compliance function has a significant role to play in this context.

The compliance function spans a broad range of activities across all areas of a firm. It deals with both conventional organizational processes such as supply chain design as well as contemporary challenges like cybersecurity. It also has a range of specialist tasks, such as regulatory compliance, anti-money laundering activities, capital market regulations and IT compliance.

The compliance function plays a significant role in the three lines of defense model, which separates operational activities from control functions.

Compliance is a very fast-paced field. Regulations are continuously evolving, with requirements at a European level and their transposition into national law being constantly refined. It is essential for the compliance function to operate effectively in three core areas by 1 | implementing a robust screening process that identifies and integrates new regulations at an early stage, 2 | engaging closely with stakeholders throughout the firm to ensure end-to-end compliance and 3 | developing essential expertise. Increasingly, core areas of compliance are intertwined with more recent topics such as ESG.

ESG compliance is a risk management approach that combines adherence to internal business process standards with sustainability aspects.

The objectives of ESG compliance are to protect the firm against external and internal shocks as well as to safeguard its reputation and integrity. ESG and compliance intersect in several dimensions that together contribute to a robust risk management strategy. This calls for strategic decisions on the role and extent of compliance involvement in ESG topics.



## 1st Line of Defense

Operative Geschäftsführung und Personen mit direkten Kontaktstellen zu Risiken und Kontrollen

## 2nd Line of Defense

Überwachungs- und Compliance-Funktionen, die im gesamten Unternehmen ausgeführt werden

## 3rd Line of Defense

Interne Revision, die relevante Standards, Verfahren und Prozesse überprüft

# ESG as cross-cutting compliance topic

While many firms have developed a tactical response to the growing diversity of ESG products, transactions and services, there is now a need for them to establish their strategic approach to consider how the key elements of the compliance framework can be enhanced in order to effectively meet the greater requirements arising from ESG-related risks:

- Regulatory requirements are increasing and are being translated into detail specifications (policies and procedures, functional design documents, controls).
- Lack of awareness leads to failure to appreciate the importance of ESG for the firm.
- Inadequate quality/availability of ESG data may lead to inaccurate analyses and higher costs.
- ESG ratings have not yet been standardized, resulting in a lack of transparency.

- ESG topics need to be integrated into the structures and procedures of the compliance function.
- Given the considerable overlap between voluntary commitments and regulatory topics, the compliance function is often consulted.

To date, many compliance functions have primarily centered their monitoring activities on products, transactions and services. Now this is no longer sufficient and they also need to be mindful of strategic elements. This means that compliance functions should consider moving into the more strategic levels (1 and 2), which will also allow them to consider specific ESG-related compliance risks (i.e., when operating at the firm level, it becomes easier for Compliance to monitor across reputational, conduct and regulatory risk).

Regulators have now prioritized ESG compliance for the prevention of greenwashing, forcing firms to enhance their systems for rating ESG products and transactions to shore up credibility. The objective is for firms to clearly demonstrate that they are meeting their ESG targets and their customers' expectations. So far, many firms have adopted relatively short-term solutions for the increasingly complex range of ESG products, transactions and services they offer. The time has now come to develop a long-term strategy to enhance and enable the compliance framework to meet the growing demands for dealing with ESG-related risks.

## Firm

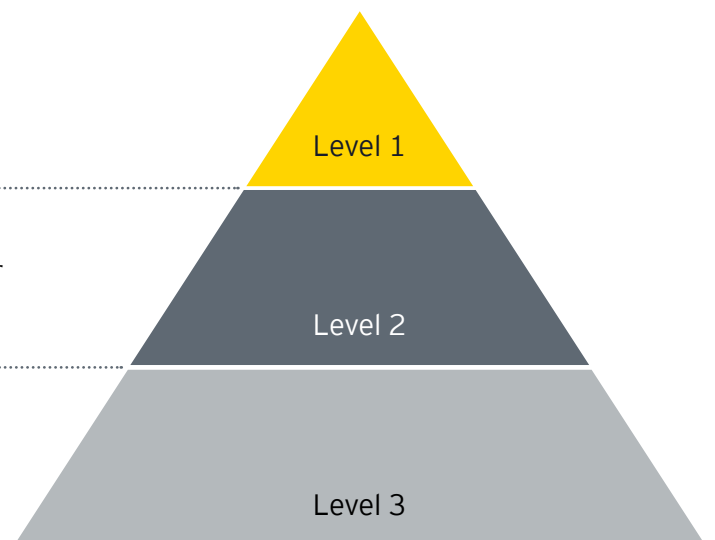
Focuses on the firm-wide ESG strategy activities

## Customers

Support the alignment of the firm's ESG strategy with customer preferences and new sectors

## Products, transactions, services

Activities that enable the implementation of the ESG strategy through products, transactions and services for customers



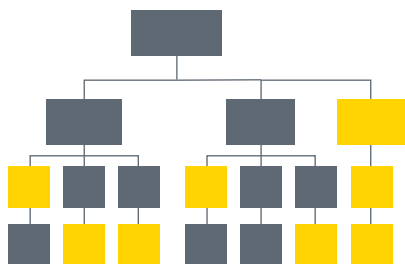
# Key questions and design of an integrated ESG compliance function

Many firms are facing the key question of how to best integrate ESG-related risks into their compliance function. There is no one-size-fits-all approach to sustainability risks. Instead, firms should start by analyzing their current

framework. In some cases, vertical integration may be more appropriate, while in others, a horizontal approach will be suitable for positioning ESG compliance risks. The approach firms take will depend on their organizational

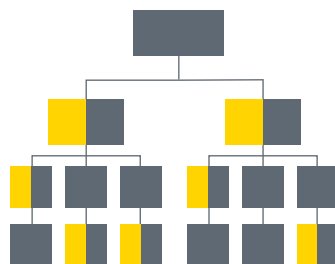
circumstances or the need to give appropriate consideration to significant ESG-related compliance risks. At the same time, the responsibilities of the first and second lines of defense play a significant role.

Some of the compliance function organizational options being considered by member firms are outlined below.\*



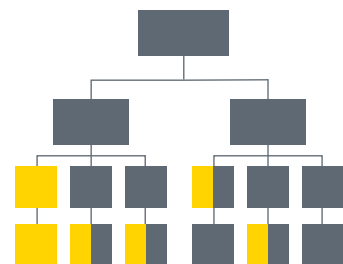
## ESG compliance pillar

- 1 | Set up a dedicated Head of ESG Compliance function, which will be responsible for the management of compliance risks
- 2 | Leverage other compliance teams (Advisory, Monitoring & Testing, Surveillance, Financial Crime/Money Laundering) who will be required to embed ESG into their compliance activities
- 3 | Establish new reporting lines into and out of the new pillar
- 4 | Coordinate through existing governance forums and arrangements and/or ESG compliance change programs



## ESG embedded into BAU\*\*


- 1 | ESG activities embedded into existing compliance functions and activities
- 2 | Coordination typically managed through:
  - existing compliance governance forums, reporting lines and escalation mechanisms; or
  - dedicated ESG compliance community under the leadership of designated compliance function ExCo members supported by senior compliance officers



## Hybrid approach

- 1 | Dedicated resources assigned within Compliance to design and implement core ESG compliance activities across the function
- 2 | Coordination with a sustainability expert group, which comprises subject matter advisors across Risk, Legal and Compliance
- 3 | Leverage other compliance teams (Advisory, Monitoring & Testing, Surveillance, Financial Crime/Money Laundering) who will be required to embed ESG into their compliance activities

\* ESG and the Role of Compliance - November 2022; published by EY and AFME.  
 \*\* Business As Usual



Compliance officers should consider three key questions to determine their approach:

1

**How do firms and their functions define the ESG strategy and embed it into their activities, including the risk and control framework?**

These questions should be answered individually, considering the firm's current structure and the defined strategy. Even if one of the approaches outlined on page 6 appears to be the best fit, however, the firm should also reflect on its long-term vision. For this purpose, various departments will need to work with management to develop an actionable strategy.

**Conclusion:** Given the global presence of financial services providers, an additional layer is required to address the complex challenges faced by compliance departments, which have to handle diverse legal and business requirements at different levels. To uphold the firm's integrity and legal compliance, it is essential for the compliance function to implement a consistent and comprehensive coverage model that includes all aspects of business activities. This requires a careful analysis of existing compliance structures and identification of areas for improvement in order to ensure ongoing compliance with regulatory requirements.

2

**How does the second line coordinate functions so as to manage compliance and reputational risks associated with ESG-related activities?**

Rigorous application of the compliance model at a global, regional, legal and business level is critical to mitigate the risks of non-compliance and the associated consequences. This means that the compliance function needs to take the initiative to ensure that the firm's policies and procedures are always up-to-date and clearly communicated to employees. Ongoing training and raising employee awareness of compliance topics is just as important in this context as regularly reviewing and adjusting the compliance response to changing regulatory requirements.

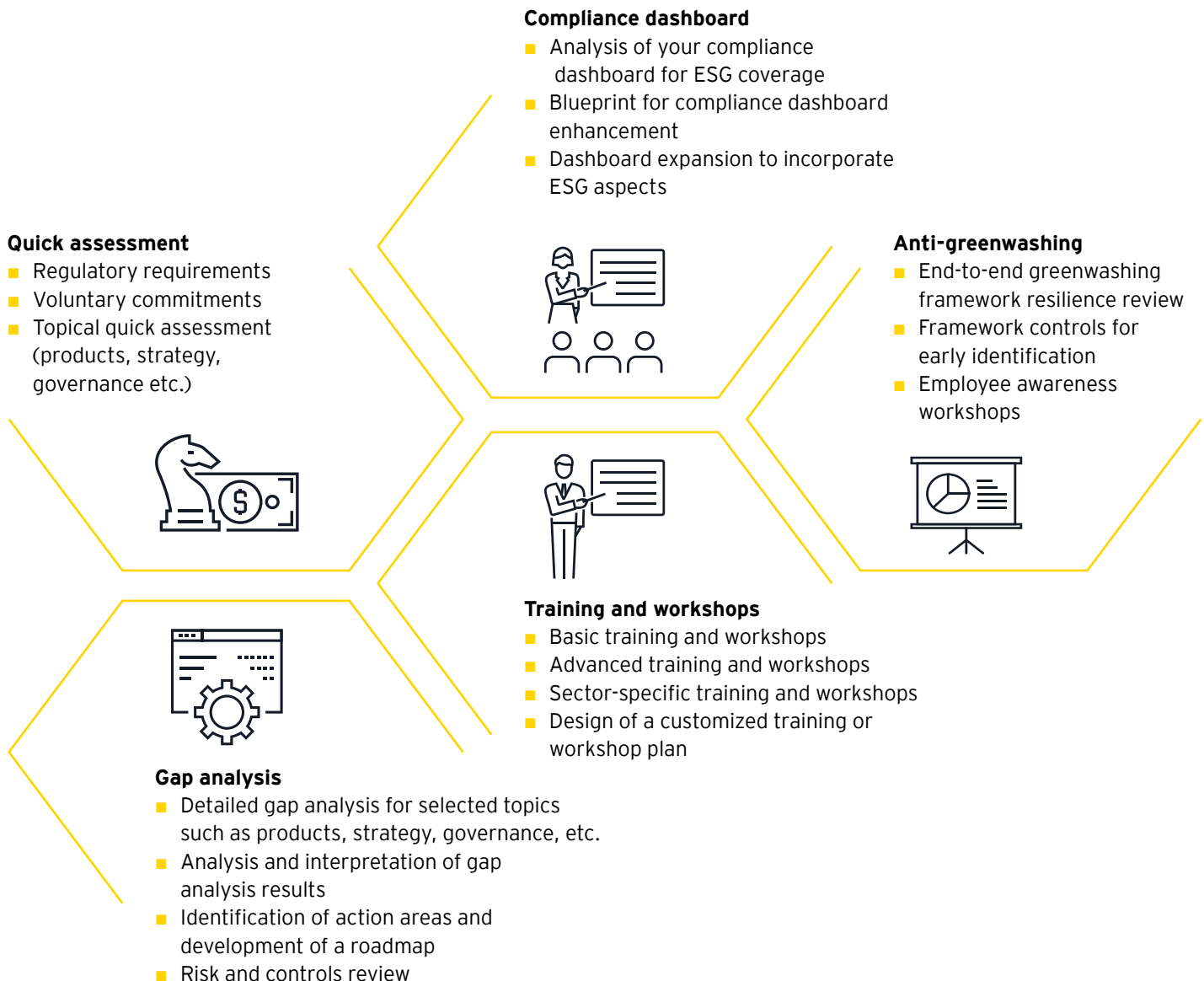
The compliance model needs to be flexible and adaptable to cater to the ever-changing demands of the global financial markets. As such, the compliance function should establish a system designed to respond promptly to new regulatory developments. Doing so will allow the firm not only to meet its legal obligations but also improve stakeholder trust and reinforce its position in the global market.

3

**How does Compliance monitor the risk arising from the ESG strategy in order to enhance ESG-related risk management (e.g., Head of [ESG] Compliance)?**

# EY solutions for integrating ESG into the compliance function

Our dedicated team has the requisite experience to assist you, drawing on its in-depth knowledge of ESG regulations and compliance as well as its extensive background in financial services and regulatory transformation. Our offering includes many services crafted to help your firm address the risks and challenges discussed in this brochure.





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