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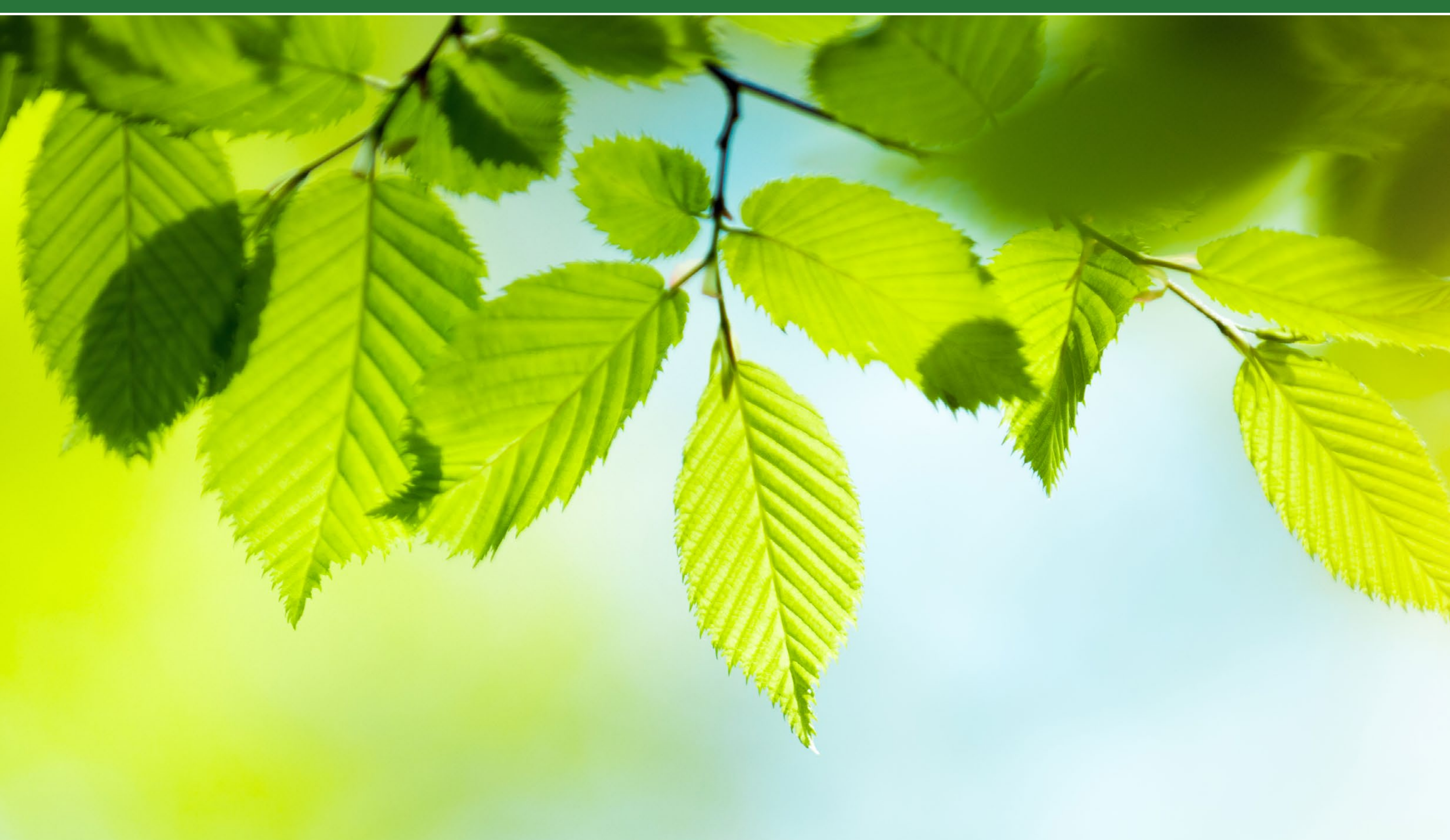

Sustainable Finance and Climate Change Risk in Financial Services

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Introduction

Financial services regulators have been particularly vocal in the last 12 months, specifically about the impact on the financial services sector as the world experiences, and attempts to respond to, climate change.

Mark Carney, outgoing governor of the Bank of England, highlighted how pressing an issue climate change is for the sector in October 2019, stating that,

" … changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset. Firms that align their business models to the transition to a net zero world will be rewarded handsomely. Those that fail to adapt will cease to exist. The longer that meaningful adjustment is delayed, the greater the disruption will be".

Policy makers and regulators seem keen to adopt both a "carrot" and "stick" approach to channelling private finance sustainably. The carrot approach is to create incentives and opportunities for firms to drive the transition to a greener economy, whereas the stick approach requires firms to identify, assess, and manage the physical and transition risks arising from climate change and incorporate those risks into their traditional risk management framework.

This briefing will summarise the key international, European, and UK regulatory developments applicable to the financial services sector that have been recently implemented, considered, or proposed, and that will form the basis for the significant changes we expect to continue in 2020.

What is ESG and why should financial services firms care?

ESG is an umbrella term for a broad range of environmental, social, and governance factors, against which investors can assess the behaviour of the entities they are considering for investment.

A number of key factors have driven the rise in the importance of ESG, both from a financial services perspective and across the wider economy. First, public concern for the environment and social equity has grown. Second, financial institutions have come to better understand the risks to investments associated with ESG issues. These may be direct risks, for instance the risk of climate-related flooding impacts to property investments and the impact of tightening regulations. Alternatively, the impacts may be indirect, such as changing consumer preferences associated with ESG issues that affect demand for products or services.

Despite a strong focus on the social and governance aspects of ESG in recent years, most of the current policy momentum relates to the "E" in ESG. Therefore, the primary focus of this briefing is environmental issues in finance, for which Carney has identified three key focus areas: disclosures, risk management, and returns.

ESG drivers and developments

Key global measures and voluntary industry initiatives

Perhaps the most influential industry body in facilitating the recent rise of ESG among asset managers in particular, has been the United Nations Principles for Responsible Investment (PRI). The six principles set out by the PRI were developed by an international group of institutional investors, and launched in 2006. When investors sign up to the PRI they commit publicly to these six principles, which include incorporating ESG issues into investment decision-making and ownership policies and seeking disclosure of ESG issues. Although voluntary, being a signatory of the PRI has become increasingly important, and is considered by investors as a good way of demonstrating their commitment to ESG.

The Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) is another key body. The TCFD aims to develop "consistent climate-related financial risk disclosures for use by companies in providing information to stakeholders". The TCFD's final report and recommendations, published in June 2017, set out information that companies should disclose to enable investors, lenders, and insurance underwriters to better understand how companies oversee and manage climate-related financial risk.

The TCFD is aiming to strike a balance between the need to raise existing climate disclosure standards and the desire to achieve widespread adoption. The recommendations are emerging as the lead framework for climate change reporting, and national governments worldwide, the EU, and NGOs have promoted them extensively. The TCFD has been officially endorsed by the UK government, and marks the start of a process that will require a significant number of additional companies to report on ESG issues.

Banking sector

In September 2019, the United Nations and a group of 130 banks from 49 countries launched the UN Principles for Responsible Banking (PRB). The group intend the PRB to provide an international framework for a sustainable banking system (comparable to the PRI for asset managers), and allow signatories to demonstrate their commitment to achieving the goals expressed in the UN Sustainable Development Goals (SDGs) and the Paris Climate Agreement.

Signatories to the PRB must commit to six key principles, and are required to take three significant steps to demonstrate effective implementation:

- **Impact Analysis:** Banks must conduct a review of their activities to identify their most significant potential positive and negative impacts on the societies, economies, and environments in which they operate. Based on this analysis, banks should identify opportunities to increase positive impacts and decrease negative impacts.
- **Target Setting and Implementation:** Banks must establish and publish a minimum of two ambitious targets relating to the positive and negative impacts identified in the Impact Analysis.
- **Accountability:** Banks must demonstrate their progress on implementing their targets and be transparent about their impacts, contributions, and adherence to the PRB.

The Sustainable Banking Network (SBN) is made up of financial sector regulatory agencies and banking associations from emerging markets that are committed to advancing sustainable finance in line with international good practice. The SBN was launched in September 2012 and has 38 member countries. SBN members work towards the dual goals of improved ESG risk management (including disclosure of climate risks) and increased capital flows to activities with a positive climate impact.

Securities sector

The Sustainable Stock Exchanges Initiative (SSE) was launched by the United Nations in 2009. The aim of the SSE is to build the capacity of stock exchanges and securities market regulators to promote responsible investment in sustainable development and advance corporate performance on ESG issues. 93 of the world's stock exchanges are members of the SSE.

At present, 12 stock exchanges specifically require listed companies to disclose ESG information. As such, the use of metrics that allow investors to evaluate ESG performance is more widespread in investments in publicly traded entities, as the greater amount of disclosures that are required allows more scrutiny. For example, the London Stock Exchange publishes recommendations on ESG for listed companies. Further, the International Organization of Securities Commissions (IOSCO) has released a Statement on Disclosure of ESG Matters by Issuers, encouraging issuers to assess the materiality of ESG factors to their business and disclose the impact, or potential impact, on financial performance.

In an effort to coordinate and harmonise ESG efforts a number of jurisdictions, including the EU, India, and China, launched the International Platform on Sustainable Finance (IPSF). The IPSF aims to coordinate approaches and initiatives for capital markets that will boost private investors' confidence in sustainable investment opportunities and increase private-sector funding in this area. According to the IPSF's launch statement, these initiatives may include taxonomies, standards, and disclosures.

EU measures

The key EU sustainable finance measures centre around the European Commission's Sustainable Finance Action Plan (the Plan). The Plan was first published in March 2018, with the aim of helping to position the EU financial sector at the forefront of establishing a green economy. The Plan was followed in May 2018 by a series of legislative proposals, which include the four following primary measures:

1 Creating a unified EU classification system (a taxonomy) for determining whether an economic activity or investment qualifies as environmentally sustainable.

This measure will establish consistent criteria for labelling a product as "green". These criteria are to be applied by financial market participants marketing sustainability-themed funds, and by Member States setting out national rules on labelling investment products.

The taxonomy is crucial to the Plan, as without a common standard for what is classed as green, the labelling of products will not be consistent, readily understood, or reliable. However, perhaps due to its anticipated significance, the taxonomy has proved controversial, and political agreement was only reached in December 2019. It is not clear at this stage when the taxonomy might take effect, but the Council has signalled that the EU should work towards establishing the taxonomy by the end of 2021, with full application by the end of 2022. As the various other initiatives outlined in the Plan will benefit from this taxonomy, many industry participants are keen to see it established as soon as possible.

2 Improving through legislation how institutional investors and asset managers disclose integration of ESG factors into their decision-making processes.

Institutional investors and asset managers will also have to show how their investments correlate to, and comply with, their ESG targets. This piece of legislation is often referred to as the **Disclosure Regulation**, and is intended to ensure that the buy-side are more transparent about the way in which they invest.

The Disclosure Regulation was adopted in December 2019, and most of its provisions will apply from 10 March 2021. It is designed to encourage uniformity in ESG disclosure, by establishing a consistent set of rules on how financial market participants inform investors on the integration of ESG risks and opportunities. These rules will address the widely reported problem of inconsistent reporting of ESG issues to date. They are designed to provide stakeholders with valuable information about the potential ESG risks of investments, and clearly delineate the potential financial impacts of those risks.

The Disclosure Regulation is supported by three pillars, which are intended to underpin its implementation:

Elimination of greenwashing. Greenwashing is the provision of unsubstantiated or misleading claims about the sustainability characteristics of an investment product. The Disclosure Regulation aims to eliminate greenwashing and, in parallel, raise market awareness of sustainability.

Regulatory neutrality. The Disclosure Regulation provides a disclosure toolkit that different financial market operators will apply uniformly. The European Supervisory Authorities will monitor harmonisation of disclosures in all relevant sectors.

Level playing field. The Disclosure Regulation covers investment funds, insurance-based investment products, private and occupational pensions, individual portfolio management, insurance advice, and investment advice, to ensure a harmonised approach across investment sectors.

3 Amending the EU Benchmarks Regulation to introduce a new category of low-carbon benchmarks.

This new market standard will help investors effectively allocate their assets into sustainable portfolios. The amendments to the EU Benchmarks Regulation came into force on 10 December 2019, and are a response to the perceived lack of uniformity among existing low-carbon indices. The EU and market participants alike considered this inconsistency to be unsatisfactory, as investors were unable to use benchmarks as reliable and easy tools to compare the low-carbon attributes of investments and portfolios. The new measures will introduce the following:

A new category of benchmarks, including two types of financial benchmark: an EU climate transition benchmark and a "Paris-aligned" benchmark that brings investment portfolios in line with the Paris Agreement. Benchmark administrators will have to publish detailed information on whether or not, and to what extent, the benchmarks ensure a degree of overall alignment with the target of reducing carbon emissions, or the attainment of the Paris Agreement objectives.

An obligation for all benchmarks (with the exception of those related to interest rates and foreign exchange) to disclose in their benchmark statement whether or not they pursue ESG objectives, and whether or not the benchmark administrator offers ESG-focused benchmarks.

4 Amending the MiFID II Delegated Acts and the Insurance Distribution Directive to help investment firms and insurance distributors to incorporate ESG factors into the advice process.

This will ensure that ESG considerations become part of the product distribution process. In terms of amendments to MiFID II and the Insurance Distribution Directive, the relevant European Supervisory Authorities (the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA)) are considering how ESG considerations can be woven into the product distribution process. However, these changes could not be finalised until the Disclosure Regulation had been agreed and so progress has been slow. Now that the Disclosure Regulation has been adopted, it is expected that work on these changes can conclude.

ESMA has provided technical advice on proposed changes to the MiFID II Level 2 measures and associated Guidelines. ESMA's technical advice to the European Commission suggested how ESG considerations can be woven into firms' organisational requirements and the product governance and suitability regimes under MiFID II. ESMA sensibly suggested a fairly flexible and pragmatic approach. For example, in relation to the product governance requirements, ESMA suggested that the amendments would not mean that investment products need always make reference, in their target market, to whether the product fulfils ESG preferences or not. This should help assuage firms' concerns that the changes could require them to place ESG preferences above other considerations, and could therefore lead to misselling risks.

EIOPA has produced technical advice on equivalent amendments to the Insurance Distribution Directive and Solvency II Level 2 measures. Further, at the Commission's request, ESMA has also produced technical advice on integrating sustainability risks and factors into both the Alternative Investment Fund Managers Directive and the UCITS Directive, and on sustainability considerations in the credit rating market.

The Commission expects the European Supervisory Authorities to provide the necessary support through the Sustainable Finance Action Plan to help the Commission achieve its goals. To this end, the European Banking Authority (EBA) has set out its own action plan on sustainable finance, which outlines the approach and timeline for delivering its mandated ESG-related work.

The EBA plans to take a sequenced approach, first looking at strategy and risk management and associated key metrics and disclosure. Second, the EBA aims to develop a dedicated climate change stress test. Third, the EBA will look into the evidence around the prudential treatment of green exposures. This third workstream could lead to more favourable capital treatment of sustainable investments, although it remains to be seen whether the European legislators would be comfortable with adjusting capital requirements.

Further, the Commission has also published guidelines on corporate disclosure of climate-related information under the Non-Financial Reporting Directive, which is applicable to EU-listed issuers, insurance companies, and banks. The guidelines (which are voluntary) incorporate the TCFD recommendations, and are designed to address the perceived gaps and inconsistencies in climate-related disclosures.

The new Commission President, Ursula von der Leyen, has emphasised that sustainable finance will be a key priority for the new Commission. The Plan forms a constituent part of the EU's broader Green Deal, formally launched in December 2019, which has been one of the von der Leyen Commission's most high-profile proposals to date. Among other initiatives, the Green Deal pledges to enshrine into law the EU's target of carbon neutrality by 2050, and that the Commission will start preparing another set of green finance initiatives, scheduled for publication in autumn 2020.

UK measures

Green Finance Strategy

On 2 July 2019, the government published its Green Finance Strategy (the Strategy), which is seen as a crucial aspect of helping the UK achieve its own target of carbon neutrality by 2050. The Strategy sets out how the government aims to accelerate the growth of green finance and enable the UK to seize the commercial potential arising from the transition to a sustainable economy. According to HM Treasury, financial services will have a bigger role to play in tackling climate change than any other sector. The Strategy has two objectives: to align private sector financial flows with clean, environmentally sustainable and resilient growth, and to strengthen the competitiveness of the UK financial sector. The government plans to use three strategic pillars to achieve these objectives:

Greening finance. Ensuring current and future financial risks and opportunities from climate and environmental factors are integrated into mainstream financial decision-making and that markets for green financial products are robust. The Strategy recognises that the transition to a green financial system will require fundamental changes to the economy and to decision-making processes, noting that the financial sector as a whole will need to incorporate these financial risks and opportunities. Actions include ensuring that all listed companies and large asset owners disclose environmental and climate change information by 2022, in line with the TCFD Recommendations.

Financing green. Accelerating the flow of private finance to support the delivery of the UK's carbon targets and clean growth, resilience, and environmental ambitions, as well as international objectives. The Strategy recognises that specific actions are required to redirect private finance flows into clean growth and environmental sectors, for example, improving access to finance for companies wishing to attract green investment.

Capturing the opportunity. Ensuring UK financial services capture the domestic and international commercial opportunities arising from the other pillars, such as climate-related data and analytics, and new green financial products and services. The government aims to consolidate the UK's status as a global green finance hub and to position the UK at the forefront of green financial innovation, data, and analytics.

Financial regulators and climate change

The government also plans to clarify the need for financial regulators to consider climate change when advancing their objectives and discharging their functions. The PRA, FCA, Financial Reporting Council, and The Pensions Regulator issued a joint statement in reaction to the Strategy, welcoming the government's action. The government must now set out concrete and specific proposals pursuant to the Strategy.

At regulator level, the PRA and the FCA began to place more importance on climate change and green finance in 2019. In April 2019, the PRA published a Supervisory Statement (SS3/19) on banks' and insurers' approaches to managing the financial risks from climate change. The PRA uses the Supervisory Statement to explain how financial risks from climate change arise, how they present unique challenges for firms, and how the PRA expects firms to take a strategic approach to tackling these risks. In particular, the PRA expects a firm's board to understand and assess the financial risks from climate change that are relevant to the firm, and expects a Senior Manager to be formally allocated responsibility for identifying and managing these risks. The PRA also requires firms to address the financial risks from climate change through their existing risk management frameworks, conduct scenario analyses to inform their strategic planning, and consider whether any extra disclosures are necessary to enhance transparency on their approach to managing climate-related financial risks.

In addition, the FCA published a Feedback Statement (FS19/6) in October 2019, as a follow-up to its October 2018 Discussion Paper on climate change and green finance.

The Feedback Statement outlines the FCA's planned next steps, including:

- Consulting in early 2020 on proposed new disclosure rules for issuers, which will align with the TCFD Recommendations, and clarifying existing disclosure obligations for climate change risks
- Carrying out further policy analysis on greenwashing, and clarifying the FCA's expectations with regard to greenwashing
- Continuing existing work on stewardship, the facilitation of investment in patient (long-term) capital, and rule changes requiring Independent Governance Committees to oversee and report on firms' ESG and stewardship policies
- Continuing various initiatives with the UK government, other regulators, and industry on these issues, including the Climate Financial Risk Forum, and the Fair and Effective Markets Review Working Group

Conclusion

In recent years, ESG implementation has transformed from a niche to a mainstream activity, as the collective attention and actions of policymakers and lawmakers have been increasingly focused on sustainability and other ESG issues.

The corporate world is also now questioning whether the prioritisation of shareholder value above all other objectives is appropriate, and whether we need a softer form of capitalism that equally prioritises other social responsibilities (or stakeholder capitalism, as it is described by the organisers of the World Economic Forum at Davos).

The financial sector is playing, and will continue to play, a central role in this economic transformation, and the "winners" will be those firms that respond best to the opportunities and obligations that will be presented in the years ahead. The developments summarised in this briefing show that the EU and the UK are looking to lead the way on ESG issues globally. While ESG has not gained the same level of traction among policymakers in other jurisdictions, this is now also starting to change.

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