Making Sense of Sustainability

Global ESG Policy Developments and Implications for 2023

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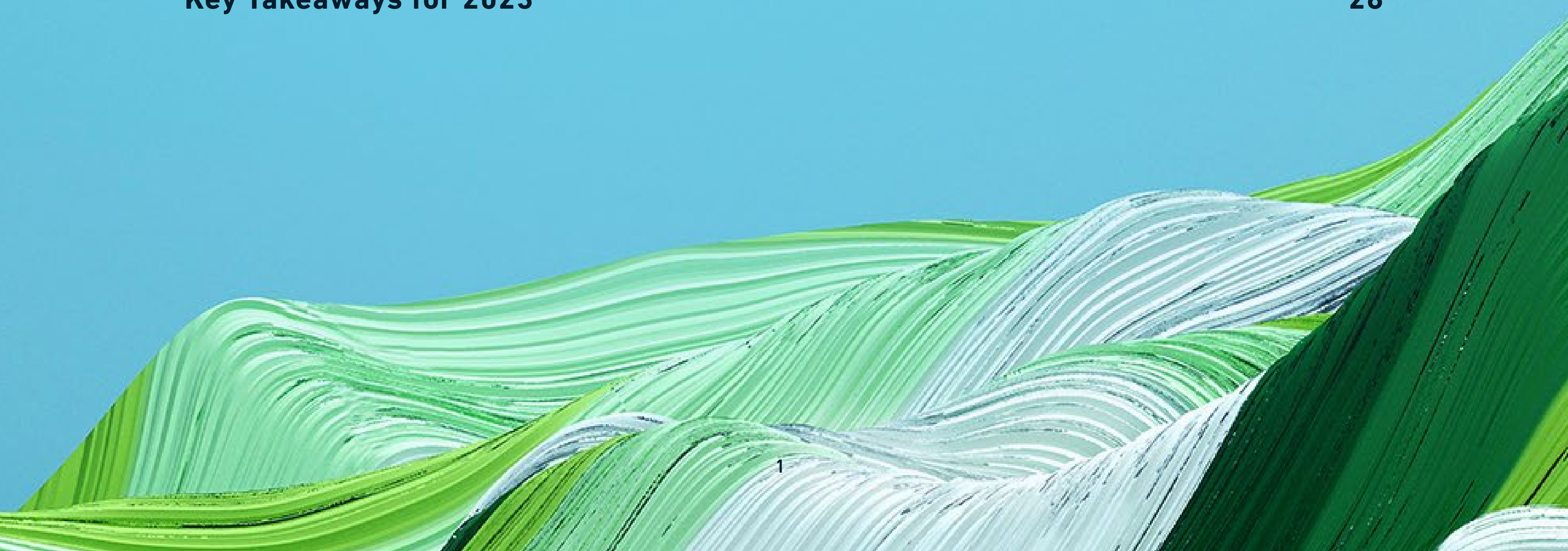
Contents



Executive Summary

Amid profound geopolitical and economic disruptions in 2022, there has been continued focus on managing risks stemming from climate change as well as wider environmental, social and governance (ESG) issues. In almost all regions, there have been increased regulatory and supervisory initiatives, and we expect this to continue throughout 2023.

The implications for investors and other financial market participants will vary — but wherever these initiatives are taking root, it is likely to mean a greater degree of disclosure about exposures to sustainability-related risks and opportunities as well as requirements to demonstrate the effective management of such risks within investment processes and business operations. In Europe, companies and financial services firms are facing increased pressure to conduct additional due diligence of their supply chains, by identifying, assessing and mitigating adverse actual or potential sustainability risks.

There are different motivations and objectivities driving the actions of policymakers. Regulators in the United States are focused on ensuring banks, investment managers and investment advisers as well as other financial market participants are effectively managing risks stemming from climate change or wider ESG matters. Whereas, regulators in other jurisdictions, notably in Europe but also parts of the Asia-Pacific region, have been set explicit mandates by governments to 'green the financial system'; in other words, to reorient private capital toward a more sustainable, resource-efficient and circular economy. However, there are three broad areas of interest:

- Investor protection from the risks of mis-selling, as interest grows in investment strategies that are designed to navigate sustainability issues, or to have positive impact
- Stability and efficiency of the financial system by ensuring that the market is able to identify and price sustainability risks and opportunities
- Directing finance away from activities in the economy that are unsustainable, and toward those that are sustainable

It is the last of these that is the most unusual in a historical context. Support for this concept is by no means universal, but the sense of urgency regarding climate change felt by some has impelled some policymakers to embrace a much more directive approach to financial markets.

Since the signing of the Paris Climate Agreement in 2015, immediate public policy priorities have been on addressing climate-related financial risks, but that is changing as governments, regulators, investors and other stakeholders expand interest to wider environmental and social-related risks (for instance, biodiversity or human rights.) Underpinning that broader focus is the United Nations Sustainable Development Goals which provide a framework for governments, companies and investors to consider the range of sustainability-related priorities.

The European Union issued a comprehensive policy agenda in 2018, and that has proven to be a base for policy considerations in certain other countries. The European Commission's International Platform on Sustainable Finance was, in fact, established to foster international dialogue and adoption of regulatory frameworks across borders; this includes the EU Taxonomy Regulation, which is a classification system for environmentally sustainable economic activities.[1] Nevertheless, while several countries have committed to developing green taxonomies, generally consistent with the overarching objectives of the EU framework,[2] major jurisdictions, including the United States, have no such plans to develop a taxonomy. On the contrary, US regulators (as well as senior Bank of England officials) have publicly criticized the EU framework on the grounds that it potentially risks companies in high-emitting sectors being denied investment.

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Mandatory climate disclosure has been a common focus across policymakers globally, with the UK, Canada, Japan, South Africa, Singapore, New Zealand and other regions committed to adopting the evolving recommendations by the Task Force on Climate-related Financial Disclosures (TCFD).[3]

Perhaps one of the most significant proposals came from the Securities and Exchange Commission (SEC) in the United States when it unveiled its proposal to mandate enhanced climate-related disclosures by public companies earlier this year. The SEC has also brought forward a proposal to enhance ESG-related disclosures by investment managers and investment advisers.[4] Both of these proposals reflect global standards and guidance established by the TCFD as well as the International Organization of Securities Commissions (IOSCO) in November 2021.[5]

Concerns about 'greenwashing' — a term used to describe the practice of a company or organization seeking to convey a false impression about its environmental impact - have become more widespread in recent years, and policymakers are intent on addressing these concerns through increased transparency as well as marketing and distribution restrictions for sustainability-linked products. US, EU and UK supervisors are expected to step up enforcement in this regard in 2023. However, imposing restrictions on the marketing of products that have unsubstantiated sustainability claims has been topical for some time, with the French financial regulator having introduced qualitative and quantitative requirements for investment funds in 2020.[6]

National investment to develop domestic industries and supply chains is important, provided that there is efficient global growth of the clean energy sector, which is essential to enable the energy transition.

As securities regulators across the globe increasingly look to prescribe 'ESG' labelling criteria to distinguish between sustainability-related financial products and/or funds, there is heightened risk of regulatory fragmentation should regulators and supervisors adopt inconsistent approaches. This could, in turn, have significant implications for how global financial market participants position their financial products across borders, and exacerbate greenwashing accusations. The current scrutiny surrounding fund reclassification in view of evolving EU and UK expectations and technical standards is indicative of this.[7]

Furthermore, while regulation and policy in this area continues to evolve, it would be remiss to ignore the effect of geopolitical events. Governments have sought to introduce substantial clean energy reforms in response to the war in Ukraine, rising energy costs and inflation, which led to dramatic price rises and demand for fresh fossil fuel projects to reduce reliance on Russian gas. Tensions between global economies of scale are starting to emerge, as certain national measures are perceived to be highly protectionist in nature, as a result of war-induced shortages playing out in terms of food and security. National investment to develop domestic industries and supply chains is important, provided that there is efficient global growth of the clean energy sector, which is essential to enable the energy transition.

In this paper, we highlight major policy developments that occurred in 2022 and discuss the implications for market participants in 2023. To do so, we use the framework we introduced in our March 2022 paper, **Making Sense of Sustainability: A Policy Perspective.**

That framework identifies five major areas of global policy aimed at:

1. **Enhancing transparency of climate and ESG risks across the financial ecosystem**
2. **Establishing a common classification system for sustainable investments**
3. **Ensuring appropriate governance and management accountability for climate and ESG risks**
4. **Incorporating climate-related financial risk into banking rules**
5. **Encouraging market-based initiatives (voluntary carbon markets or ESG ratings)**

Chapter 1

Enhancing Transparency

Mandatory Sustainability-Related Disclosures Gain Ground in 2022

As governments look to accelerate economic transitions in line with their national climate or wider sustainability-related commitments, and regulators seek to standardize sustainability claims made in relation to financial products, immediate public policy measures have been geared toward increased transparency.

Transparency is therefore sought with respect to how and where sustainability-related risks and opportunities are factored into investment decisions.

The most basic building blocks of investment decisions are the regulated periodic disclosures made by listed companies. These have not historically contained much information relating to sustainability; they have been gradually supplemented by additional public and private disclosures which form the basis for ESG datasets created by a wide range of service providers. These combine company disclosed data and additional sources into a system of evaluation of sustainability and other attributes. Issuers are faced with multiple competing requests for information, and correlation between the assessments of providers is low.[8]

In some cases, these datasets can provide the relevant disclosures for the emerging regulations, but some policymakers, issuers and investors have expressed concern about the potentially large influence of the evaluators, set against their unregulated nature, and contrasted them with credit rating agencies which operate under a more strictly regulated environment. The relatively sparse set of regulated disclosures, combined with the increasing requirements for investors to disclose, has encouraged dialogue about more standardized issuer disclosures.

Across the financial services sector, there is a dual focus on enhancing climate and wider sustainability-related disclosures by issuers and investors. There are several drivers of this, ranging from increasing information flows across the investment chain to standardizing financial product disclosures such that they do not mislead investors or consumers as a result of rising sustainability-related products and services.

Today, the TCFD is a well-established framework for incorporating climate-related financial risks into governance, strategy, risk management and disclosure. According to the 2022 TCFD progress report, all regions have significantly increased disclosure over the past three years. Europe is leading at 60 percent across the 11 recommended disclosures, 24 percent higher than the Asia Pacific region, which is the next highest region. There has been positive improvements elsewhere, with the average level of disclosure in North America growing by 12 percent between 2019 and 2021, to 29 percent in 2022.[9]

The TCFD framework is being extended to also account for nature-related financial risks (e.g., biodiversity) now that the Task Force on Nature-related Financial Disclosures (TNFD) has been established.[10] However, the most promising development of 2022 was the work toward a global baseline of sustainability-related standards by the International Sustainability Standards Board (ISSB).[11]

Today, the TCFD is a well-established framework for incorporating climate-related financial risks into governance, strategy, risk management and disclosure.

The ISSB issued two sets of Exposure Drafts covering general sustainability principles and industry-specific climate disclosures in 2022.[12] Those standards do not seek to reinvent the wheel, rather they leverage existing frameworks such as the TCFD as well as the Value Reporting Foundation (VRF – formerly SASB). For investors and companies already using those frameworks, this should be a highly welcome development.

In addition, the ISSB's stated focus on ensuring "interoperability" across jurisdictions should be particularly welcomed by global investors and companies, given they will be subject to different regulatory regimes from around the globe. The question remains to what extent the ISSB standards will be adopted and endorsed by jurisdictions? Taking a look at the first Exposure Drafts could be a useful indication.

For instance, at this stage, the ISSB is utilizing existing definitions and concepts used in International Financial Reporting Standards, but these may differ in those jurisdictions that apply a different accounting framework (e.g., US GAAP). It may be more plausible to envisage alignment between the ISSB and the incoming EU and UK standards, since foundational accounting concepts are similar, but even then the EU has introduced concepts such as "double materiality," which the ISSB has previously said it would not adopt.

This will be a crucial year for measuring the success of the ISSB, as jurisdictions such as the EU forge ahead in developing pan-European standards and final ISSB standards are not expected until towards the end of Q1 at the earliest.[13]

There are several notable developments, regionally. For instance, the US Securities and Exchange Commission (SEC) released proposals that would require additional climate-related financial risk disclosures by public companies,[14] as well as wider ESG disclosures by investment managers and investment advisers.[15] The SEC faces significant legal challenge from politicians and business groups, with lawsuits already filed. Chairman Gary Gensler frequently commented on the SEC's intention to finalize rules on public company disclosures by end of 2022. However, the SEC had to reopen its comment period due to a technical glitch, forcing any announcement of final rules into 2023. In addition, the SEC is expected to release another proposal relating to human capital disclosures, but as of the end of 2022 this had not occurred.

Meanwhile, in the EU, the European Commission adopted long-awaited regulatory technical standards (RTS) that supplement the Sustainable Finance Disclosure Regulation (SFDR) in April 2022. These aim to specify the presentation, format and content of SFDR disclosures that came into effect on 1 January 2023. The most recent update was to reflect the inclusion of gas and nuclear energy economic activities (see further details on that below). The ESAs are expected to deliver additional RTS on principal adverse impacts (PAI) products by 28 April 2023. However, the Chairs informed the European Commission that they would be delayed by around six months.[16] As financial market participants and EU national competent authorities grapple with implementing evolving disclosure requirements, the European Supervisory Authorities are turning up the heat on greenwashing,[17] and have followed suit in issuing guidance that seeks to restrict the use of sustainability terms in investment fund names where misleading.[18]

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The Financial Conduct Authority (FCA) in the United Kingdom has also proposed to introduce sustainability disclosures and labels for investment funds, which would incorporate restrictions on the use of sustainability related terms (e.g., 'ESG', 'Climate', 'Sustainable') in fund names. However, the FCA states that it has sought to align with the SEC proposals as well as existing disclosures and product categories outlined in the EU's SFDR. The FCA also emphasizes that its starting point is different. The FCA's proposed regime has a broader scope given the focus on consumer-facing disclosure.

But alignment across different regimes is lacking and a serious obstacle to promoting transparency

In order for investment managers to provide comprehensive and consistent disclosures across their products and portfolios, the underlying data supplied by investee companies needs to be clear, reliable and comparable. A lack of alignment across different regions and regimes, with respect to the terminology and definitions used in relation to sustainable investments, is a significant obstacle for global firms, which are under pressure to disclose in accordance with multiple regulatory or voluntary regimes.

Moreover, a good example is the debate regarding the feasibility of accurately quantifying all 15 categories of 'scope 3' emissions, often referred to as value chain emissions. Scope 3 emissions frequently represent the majority of an organization's greenhouse gas (GHG) emissions but may be hard to accurately measure as they are the result of activities or assets not controlled or owned by the organization itself.

In October 2022, the ISSB unanimously agreed that its forthcoming framework would seek to mandate not only scope 1 and scope 2 GHG emissions, but also scope 3. The ISSB intends to enable this through existing methodologies established by the GHG Protocol.[19] In view of the significant challenges with scope 3 emissions reporting, the ISSB will consider appropriate 'safe harbor provisions' to safeguard companies from legal liability when disclosing scope 3 information.

There has been significant pushback against the SEC's inclusion of disclosure around scope 3 emissions.

In contrast, there has been significant pushback in the US against the SEC's inclusion of disclosure around scope 3 emissions in its proposal. And the issue around scope 3 data has implications for institutional investors and asset managers as scope 3 emissions data is increasingly a requirement for portfolio analytics and portfolio construction. However, there are questions around the robustness of scope 3 emissions data in portfolio construction in particular. Uncertainties include the challenges of obtaining data from value chain companies, nascent measurement methods, reporting period differences, and lack of clear standards on disclosure.

But it's not just scope 3; there is also a divergence in other indicators, such as weighted average carbon intensity, absolute carbon footprints, and green-to-brown revenue ratios, just to name a few.

Inconsistent regulatory product/fund disclosure rules will be very challenging for global firms and their clients. Look closer at Europe, for example, where the EU Sustainable Finance Disclosure Regulation leaves room for interpretation. The definitions of "good governance" and "sustainable investment" can be interpreted by financial market participants subject to the regulation in a number of ways.

For example, there is variation in how financial market participants define a sustainable investment and how that is reflected in their disclosures. Putting aside the lack of comparability this creates across the market, such inherent inconsistency is bound to amplify accusations of greenwashing should an investor disagree with the assigned classification/label of a particular security. Absent regulatory consensus on what constitutes a "sustainable investment," mismatches between an investor's expectation of "sustainable investment," which is often subjective and determined according to individual preference,[20] and the financial products offered to them will be inevitable.

Inconsistent labelling of products by global regulators adds to the challenges faced by managers in delivering against the sustainability needs of their clients. Global product providers in particular will have further challenges to ensure that a single strategy can be delivered and marketed consistently across the globe. Although SFDR is a disclosure regulation, it has been interpreted and accepted as a de facto labelling scheme.

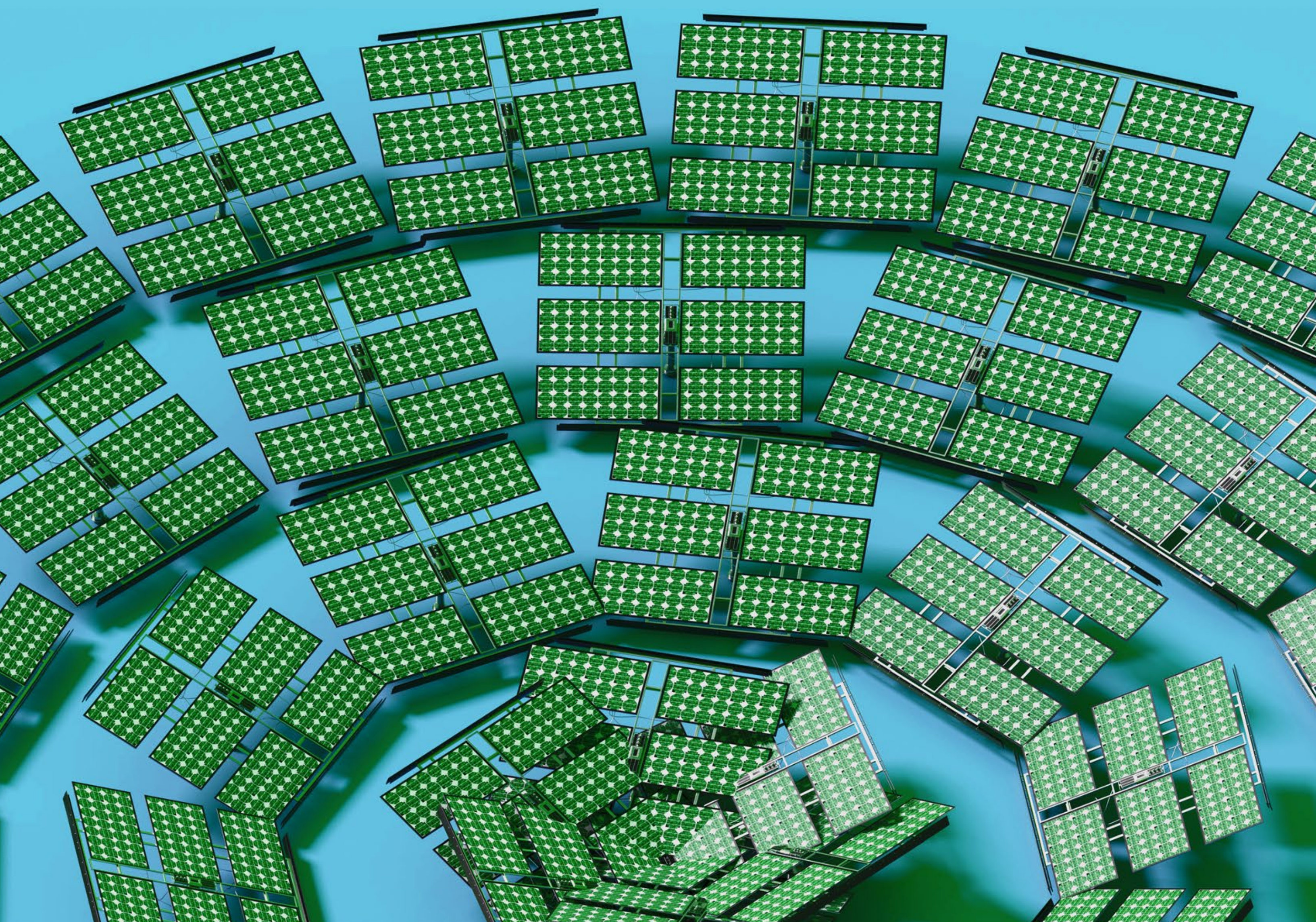
The UK, which originally suggested five product labels, has now revised that to three including: "sustainable focus" for products with environmentally or socially sustainable investments; "sustainable improvers" for products with investments that aim to improve environmental or social sustainability over time; and "sustainable impact" for those investing in solutions to environmental or social problems. Investment managers can choose whether or not to apply the labels, but there would be restrictions on the marketing and distribution of sustainability-linked funds without one.
The Financial Conduct Authority (FCA), responsible for the new label proposals, states that it has sought alignment with similar regimes in the EU, US and at global level (the ISSB) but is "starting from a different place" given the focus on developing consumer-facing information.
The deadline for feedback on the proposal is January 25, 2023 and is not expected to be brought into effect until June 30, 2024.

The need for transparency in an environment where data is unreliable or inconsistent implies that the asset management industry will need to exercise more conservative judgments when articulating the investment process and naming funds. In addition they might consider providing as broad a set of data as possible about the characteristics of portfolios. The counterpart to this is the need for distributors, advisers and investment consultants to develop deeper insights into the investment processes and issues faced by managers, for example in emerging markets, in order that they can be effective in their selection of sustainable investments if required. Labelling regulation might be a useful development to combat mis-selling, but there is also a role for enhanced scrutiny of the investment process from intermediaries.

Asset owners will be potential beneficiaries of enhanced disclosure, but in some countries they might also be expected to provide disclosures either to future beneficiaries, if pension funds, or to regulators who might see some degree of financial stability risk if their aggregate size was substantial in comparison with the economy.

Chapter 2

Establishing a Taxonomy for Sustainability



The Prospect of a Single Global ESG Taxonomy May Be Waning

Green taxonomies seek to introduce classification systems in order to identify economic activities that will move a country toward meeting specific targets related to priority environmental objectives.[21] As mentioned, there is no intention to introduce such a taxonomy in the United States.

It therefore remains to be seen to what extent the implementation of national taxonomies elsewhere could lead to barriers in cross-border investments.

The EU's framework contains a comprehensive list of economic activities that make a substantial contribution to environmental targets regarding climate change adaptation and mitigation. Such targets usually correspond to an aggregate outcome that a country wishes to achieve over a defined timeline, such as, a net reduction in emissions or deforestation by a given year. This is done by clearly defining which economic activities count as environmentally sustainable through the adoption of technical screening (or performance) criteria.[22] Under the EU framework, companies and financial market participants – including asset managers, pension funds, banks and insurers – are expected to use the taxonomy framework, including underlying screening criteria, in order to disclose a percentage of alignment across their businesses and/or portfolios.

But finalizing the EU Taxonomy Regulation has not been without controversy. Political debate intensified in 2022 as the EU altered its approach to include nuclear and natural gas-related activities as taxonomy-eligible investments. This underlines an earlier point made in this paper: War-induced shortages, especially in Europe, can be considered a catalyst for shifting public policy focus in a way that acknowledges the benefits of so-called transitional activities, given insufficient supplies of clean energy technologies, for example. It's clear that the notion of a "just" and "equitable" transition will be paramount to moving any country toward its sustainability goals.

As mentioned, the EU Commission's International Platform has sought to 'export' the Taxonomy Regulation framework outside of the EU (e.g., common ground EU-China taxonomy). And it seems as if the EU standard is being leveraged elsewhere with the UK, Singapore, Malaysia, in addition to China, incorporating the core six EU environmental objectives as a framework on which to develop national taxonomies. At the international level, the ISSB issued a consultation in May 2022[23] on a taxonomy for digital reporting representing the disclosures presented in the ISSB Exposure Drafts. This is not the same concept as the exported EU framework; that is, it doesn't outline specific environmental objectives and technical screening criteria, but rather the ISSB is developing a digitized format that will allow users of sustainability information to easily compare disclosures across companies.

Momentum toward a single global taxonomy/classification system for economic activities that make a substantial contribution to environmental or social objectives has somewhat diminished, despite some G20 leaders initially expressing support for such an initiative. Part of the reason may be disagreement with the EU's current approach, which fundamentally looks at the world's assets as 'brown versus green,' as opposed to acknowledging that there are a number of economic activities that eligibly contribute to the overall climate transition. It will also be quite some time before product providers start to develop strategies focused on taxonomy-led criteria.

In this context it is also important to note that activities aligned with the latest EU taxonomy, and therefore fitting the EU's definition of a sustainable activity, only comprise a relatively small part of the world's economic output. Measurement methods also vary here but an attempt to measure the amount of taxonomy-aligned activities of globally listed companies usually results in single digit alignment in percentage terms. Hence, fully aligning a portfolio with taxonomy-aligned activities for investors that strive for or need diversification will lead to challenges.

Instead focus has shifted to the interoperability of national taxonomies

Multiplication of regional and/or national taxonomies could stifle cross-border investing (with potential knock-on effects to market liquidity, for example). This is exacerbated by the lack of actual guidance regarding the interoperability of national taxonomies. It remains to be seen whether interoperability can be achieved in practice given that sustainable development goals will necessarily differ across regions due to different sustainability objectives.

Moreover, and with most net zero frameworks identifying stewardship and engagement as a critical tool, it is still to be evaluated by the

The EU's current approach fundamentally looks at the world's assets as 'brown versus green,' as opposed to acknowledging economic activities that contribute to the overall climate transition.

market how a potentially overly prescriptive approach that is focused on diverting capital toward taxonomy-aligned activities at the expense of non-taxonomy-aligned activities would interact with the view that stewardship and engagement is an important lever for investors.[24]

National preferences have been driving some aspects of taxonomy and these are continuing to be quite strongly differentiated around the world. For example, the debate about whether nuclear and gas should be considered 'green' saw divisions across eastern and western European countries. Beyond climate, such as considering other environmental or social objectives, there is even less likelihood of agreement on issues such as human rights, labor laws, healthcare, etc. And at the same time, there are countries that may want to demonstrate they are an ESG leader by differentiating themselves from the EU's taxonomy.

A lack of alignment around taxonomies may have implications for market participants. Underlying the taxonomies are technical screening criteria, so if investors and asset managers are trying to measure portfolio alignment and the screening criteria is inconsistent, there will be different percentages depending on what taxonomy is being used.

Furthermore, there may be a risk of limited recognition of transitional activities, to the extent that the green to brown delineation of activities could deter investments away from 'brown' activities. This would be detrimental to the overall goal of moving entire economies to a more sustainable trajectory, as it may encourage 'brown-spinning' (selling off of brown assets).

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Chapter 3

Ensuring Good Governance

Momentum Builds for Good Governance of Sustainability Risks and Opportunities

For investors, it is well established that effective board governance is the most valuable mechanism to ensure that sustainability risks and opportunities are managed to deliver long-term value to shareholders.

Effective board governance also benefits other stakeholders and so as the focus grows on managing sustainability issues, the first place to start has been to examine the degree to which this has been an area of focus for boards, and how they are exercising their oversight.

Climate risk in this context refers specifically to the financial risks the company and its shareholders face as a result of climate change. It does not refer to the risks that society at large faces from climate change. That said, there are increasing examples of companies facing legal action from city governments, citizens' groups and NGOs on the basis that their greenhouse gas emissions have contributed to climate change.[25]

Since the establishment of the United Nations Framework Convention on Climate Change in 1994, there has been increasing momentum around how boards manage and address climate-related risks and opportunities. At its 2019 annual meeting in Davos, the World Economic Forum (WEF) published principles for corporate boards on how to establish climate governance at their companies.[26]

Of course, this guidance was based on the TCFD framework since the first pillar provides recommendations on the integration of climate-related risks into governance. With supervisors increasingly aligning their expectations to reflect the TCFD recommendations, there is heightened focus on ensuring board-level attention to climate-related issues in addition to senior management expertise.

Some supervisors – notably in the UK and EU, but also in Hong Kong and Singapore – expect climate factors to be specifically incorporated into internal governance frameworks and require greater clarity around firms' strategic responses to climate-related risks informed by scenario analysis and extraordinary stress testing exercises, while also requiring an alignment between remuneration policies and sustainability risk objectives. In terms of adapting business models to reflect the impact of climate change, the European Banking Authority, as an example, suggests setting a strategic ambition or target based on the Paris Agreement, aligning portfolios accordingly.[27]

Another major development was the issuance of draft climate risk management principles by the Federal Reserve Board (FRB) at the end of 2022.[28] Although the FRB's proposed approach is very similar to that of the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC), there is considerable added emphasis on the role of the board versus senior management, which means governance arrangements to manage climate-related financial risks are highly detailed by comparison. The FRB is expecting comments to its proposal on February 6, so the final standards will not be available until later in 2023.

From an asset management perspective, stewardship practices have played a crucial role in bringing about the necessary board-level/senior focus on climate-related risks and opportunities. Stewardship codes have been focused on sustainability issues for some time, with the first being launched by the UK Financial Reporting Council (FRC) in 2011,[29] which has led to other jurisdictions (e.g., Japan) following suit. In July, the FRC released a report on the influence of the UK Stewardship Code 2020 on asset management practices and reporting.[30] The report "shows that the quality of engagement has improved under the influence of the Code, and investors are collaborating more to influence issuers and the wider market. There is still some way to go on reporting outcomes, and [the FRC] will continue to work with applicants to improve this."[31]Meanwhile, the EU has issued a comprehensive legislative proposal on corporate due diligence, supplemental to the incoming corporate sustainability reporting rules. The due diligence proposal would initially apply to large EU limited liability companies before being extended to mid-size companies in "high-risk sectors."

The EU Commission's proposal defines high-risk sectors, for example, as textiles, agriculture, forestry, food, mineral resource extraction, and metals productions. However, the European Parliament is proposing to extend this definition to capture financial services, whereas the Council (representing EU countries) has opted to remove financial services from the scope of this proposal, leaving its inclusion to the discretion of individual EU countries. Additionally, the extraterritorial nature of the proposal means that certain non-EU companies operating in the EU market will also have to apply the due diligence requirements. Ultimately, the EU wants to place greater focus on sustainability risks emanating throughout the supply chain, underpinned by processes and controls together with new director duties. Negotiations between the EU Commission, EU Parliament and Council are not expected to start until, at least, Q2 2023.

Globally, the UN-backed Principles of Responsible Investing (PRI) was set up in 2001 and has become a widely recognized framework for signatories to demonstrate general sustainable investing credibility and the impact of their stewardship in the context of climate change.

With focus on climate related governance

In 2022, we saw increased focus globally on specific governance requirements to oversee and manage climate-related financial risks.

This, by and large, is a result of governments mandating TCFD recommendations in many different regions. Some supervisors are introducing more specific board requirements. For example, in the US, the SEC is proposing to require public companies to disclose additional details regarding board oversight and management oversight.

While many companies already integrate climate-related financial risks into their oversight functions, the level of detail required by the SEC's proposed rules exceeds the degree of disclosure most companies voluntarily provide in existing sustainability reports, as well as in other SEC disclosure requirements related to risk oversight. Requiring disclosure about management oversight is notable, as this goes further than previous SEC disclosure requirements related to oversight of key risks.

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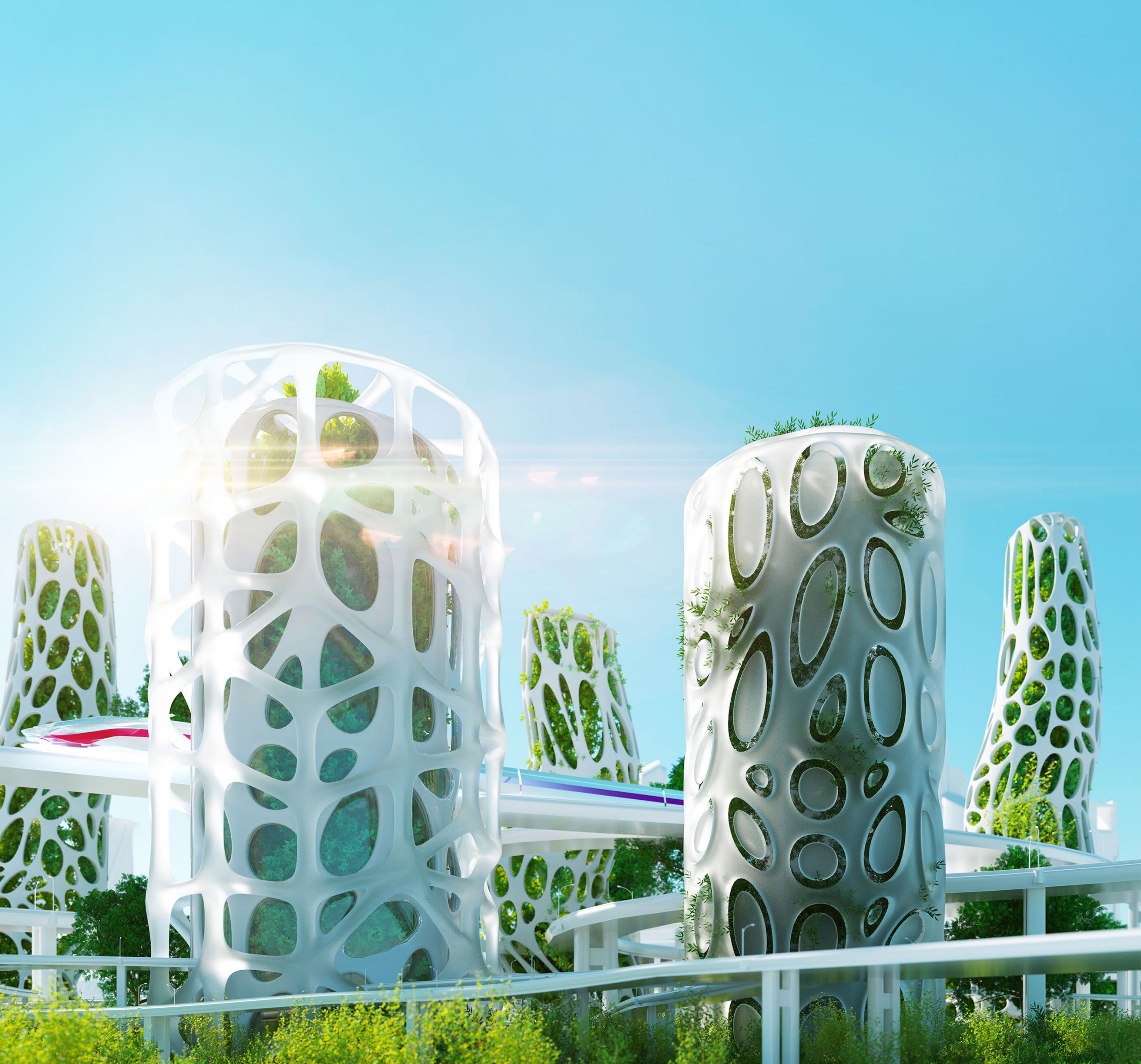
Chapter 4

Incorporating Climate Risks into Banking Rules



Banks and Their Supervisors are Continuing to Evolve Climate Risk Management

Central banks and financial regulators widely acknowledge that climate change poses a potential source of risk to the global financial system.[32]

While other areas of policy often concern the full spectrum of sustainability risks, considerations for the banking sector have focused mainly on climate-related risks. Risks stemming from climate change can be categorized into physical risks resulting from things like adverse weather events or transition risks associated with moving toward a low-carbon economy.

Increasingly, banking and insurance regulators are exploring changes to provisions relating to governance, business strategy, risk management and disclosure, to ensure climate-related risks are properly accounted for and built into decision-making processes, including capital assessment and allocation.[34] We have seen policymakers and governments articulate this across three dimensions: supervisory practices and guidance; climate stress testing and scenario analysis; and adjustments to capital requirements.

In terms of supervisory practices, the European Central Bank (ECB) issued final guidance in November 2020,[35] laying groundwork for how the ECB expects banks to prudently manage and transparently disclose such risks under current banking rules. In 2021, EU banks conducted a self-assessment in light of the supervisory expectations and were required to develop plans to bridge any gaps. Then, in 2022, the ECB conducted a full supervisory review of banks' practices and communicated follow-up actions where needed.

Moreover, in 2022, the Basel Committee on Banking Standards issued its global principles for climate risk management and supervision.[36] These are expected to inform national approaches in regions where there has not been much focus on the integration of climate risk into banking rules. This was evident in some cases where the BCBS draft principles shaped the publication of the OCC's proposed framework for large banks in December 2021.

As mentioned, the FRB's recent proposal mirrors that of the OCC (and FDIC) in terms of leveraging the BCBS principles to define how to integrate climate risk into governance, business strategy and risk management (including scenario analysis), consistent with TCFD.

However, no more than the governance-related aspects, the FRB strengthens expectations regarding the risk management of climate-related financial risk, with no clarity on its interpretation of "material," despite using the term frequently. It also remains to be seen how the FRB requirements will interact with the SEC climate disclosure proposal, if it were to be finalized as drafted.

Supervisory Stress Test vs Scenario Analysis

In Europe, the ECB extended the 2022 supervisory stress test to focus on climate-related risks; similarly, the Bank of England ran a biennial stress testing exercise for UK banks the year prior. Fundamentally, although terms of those exercises were different, the results from both revealed that while there are improvements to be made, banks are able to withstand near-term risks stemming from climate change. In 2023, we expect more regions to weigh the pros and cons of supervisory stress tests versus scenario analysis. It will be interesting to see the results of the FRB's pilot exercise with six of the largest US banks.[37]

But Capital Charges Appear To Be A Long Way Off

Originally touted by the EU Commission in its 2018 Action Plan on Sustainable Finance, some policymakers have been looking at the possibility of introducing a 'green supporting factor' or 'brown penalizing factor,' which essentially means adjustments to risk weights to reflect sustainability-related risks. The European Banking Authority was mandated by the EU Commission to explore whether and how environmental risks are to be incorporated into the Pillar 1 prudential framework for credit institutions and investment firms.

In May, the EBA issued a discussion paper to solicit stakeholder views on a number of key elements, such as time horizon, inclusion of forward-looking elements in the prudential framework, and the overall calibration of own funds requirements.[38] The European Banking Authority (EBA) aims to adopt a risk-based approach to ensure that the capital framework reflects underlying risks and supports resilience of financial institutions, but clarifies that it does not consider the capital framework appropriate to achieve specific environmental objectives. A final report is expected from the EBA sometime this year.

The Bank of England, on the other hand, has gone on record to warn against such measures, at least for the time being. In fact, UK regulators have given thoughtful consideration to the question of incorporating climate "transition risks" into the risk-weighted asset framework, a key element of capital requirements.

A blogpost by two senior Bank of England officials[39] outlines steps such as understanding how such risks are captured by the current regulatory framework; determining a time horizon; and deciding what risk weights to change and how to calibrate them.

However, the officials' conclusionary remarks make clear that given the current time horizon over which capital is set, the uncertainty of transition risks manifesting over those horizons and the results of supervisory stress test exercises, "the argument for regulators to apply a compensating adjustment to risk weights now looks challenging." They go on to say that further analysis and prudential tools would be required, in the first instance, before calibrating any regulatory adjustment. They also highlight that emerging evidence from international exercises, such as implementing the climate scenarios developed by the Network for Greening the Financial System, so far suggests that banks are unlikely to face significant losses in the very near term.

Chapter 5

Encouraging Market-Based Initiatives

Renewed Momentum Around Carbon Offsets Following COP27, Plus More Focus on ESG Data and Ratings

At COP27 in Egypt, US special presidential envoy for climate, John Kerry, together with the Rockefeller Foundation and the Bezos Earth Fund, unveiled the Energy Transition Accelerator (ETA)

ETA is a new carbon credit trading platform that would allow US companies to shop for certified carbon credits derived from renewable energy projects in developing countries. These countries, in turn, would benefit from new sources of financing for their transition from fossil fuels. The ETA, which is expected to be operational in a year, will be open to companies that commit to net zero no later than 2050 and excludes fossil fuel producers. African countries including Nigeria, Egypt and Kenya announced the Africa Carbon Markets Initiative to scale voluntary carbon markets. Separately, measures that are complementary to transparency and integration rules such as addressing gaps in ESG data and ratings are garnering more attention. The IOSCO released final recommendations on the use of ESG ratings and data products in November 2021. The EU, following strong calls from the European Securities and Markets Authority (ESMA), France and the Netherlands, had already conducted consultative work on the possible introduction of new legislation regarding ESG ratings and (possibly) data products, which the EU Commission is expected to bring forward next year. The UK also solicited public comment on the ESG ratings and data market, with a view to publishing a final policy statement next year. The FCA has also set up an industry taskforce to help devise a code of conduct for data providers. In practice the dependency on ESG data vendors is well understood; this is particularly pronounced in the context of indexation benchmarking, where often the benchmark providers also own the ESG research function employed for index construction. What is also well understood is that variation prevails across all areas of ESG related assessments - be it ratings, climate metrics, business activity research or norms based research – between vendors. However, how to deal with these variations is something that the market is still digesting.

In light of the constantly moving regulatory framework, a period of stability would be welcome so market participants, regulators and other ESG organizations could take stock to evaluate what works. It is critical that global regulators collaborate and ensure interoperability and consistency in their approach in order to truly address the needs of investors and other market participants, and ensure markets play a role in enabling the global energy transition and not hindering it.

Key Takeaways for 2023

As 2022 drew to a close, the pace of announcements around ESG regulations seemed to accelerate, highlighting a key point we previously made, that global ESG policy is constantly evolving and very much a moving target for investors and public companies.

What's more, keeping track of regulatory developments requires a global understanding as regulators and market participants around the world learn from each other about what works and what doesn't. Since ESG policy is not just complex but interconnected and fluid, we aim to publish more regular updates in 2023, helping to provide another tool for investors to understand and prepare for the changing regulatory landscape.

As part of that process, we share some of our takeaways here

We expect 2023 to be a crucial year for measuring the success of the ISSB, as jurisdictions such as the EU forge ahead in developing pan-European standards and with final ISSB standards not expected until the end of Q1 at the earliest.

Recent policy developments in the US will increase the focus of US-based market participants (investment funds, investors, and public companies) on ESG in 2023.

The EU's policy agenda will continue to drive the agenda for global investment managers and global companies doing business in Europe.

ESG is increasingly becoming a communications issue. While so many gaps still exist in regulations, both within regions and between regions, careful communication surrounding any ESG offerings will be increasingly important, especially to protect against allegations of greenwashing.

Following new initiatives around carbon markets at COP27, we expect greater interest in 2023 in voluntary carbon markets with the possibility of these markets becoming an important tool to enable the energy transition.

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