Sustainable Finance

The Regulatory Context

As part of the 2019 United Nations General Assembly, UN Secretary-General Antonio Guterres hosted the Climate Action Summit on 23rd September. Major announcements were made, though the Extinction Rebellion may disagree, to boost momentum around climate change and recognise that the pace of climate initiatives must rapidly accelerate.

65 countries committed to cut greenhouse gas emissions to net zero by 2050, while over 100 major companies delivered concrete actions to align with the Paris Agreement targets adopted in 2015 and to speed up the transition to a green economy.

Among these announcements, a new set of UN Principles for Responsible Banking was officially launched. 130 banks have signed up to these so far. The principles require banks to 'publish and work towards ambitious targets' across six different principles, aligned with the UN Sustainable Development Goals.

Since the adoption of the Kyoto Protocol in 1997, the world has seen a number of initiatives, at both a country and corporate level – the most important one being the 2015 Paris Agreement. Despite international commitments to keep global warming well below the 2 degrees target agreed in Paris[1], the CO_2 stock in the atmosphere is still rising. To meet this target, carbon emissions need to be cut by 45% by 2030 and reach net-zero in 2050[2].

Banks should ensure their willingness to sign up to the UN Principles for Responsible Banking translates into real action, which supports the 2030 commitments. There has been a mixed experience with the adoption of voluntary codes by financial institutions in the past. Regulators may need to ensure there is sufficient incentive.

[1]United Nations Framework Convention on Climate Change, *Paris Agreement*, December 2015
[2]Intergovernmental Panel on Climate Change, Special Report, Global Warming of 1.5 ºC, October 2018

Sustainable Finance

The Regulatory Context

Figure 1

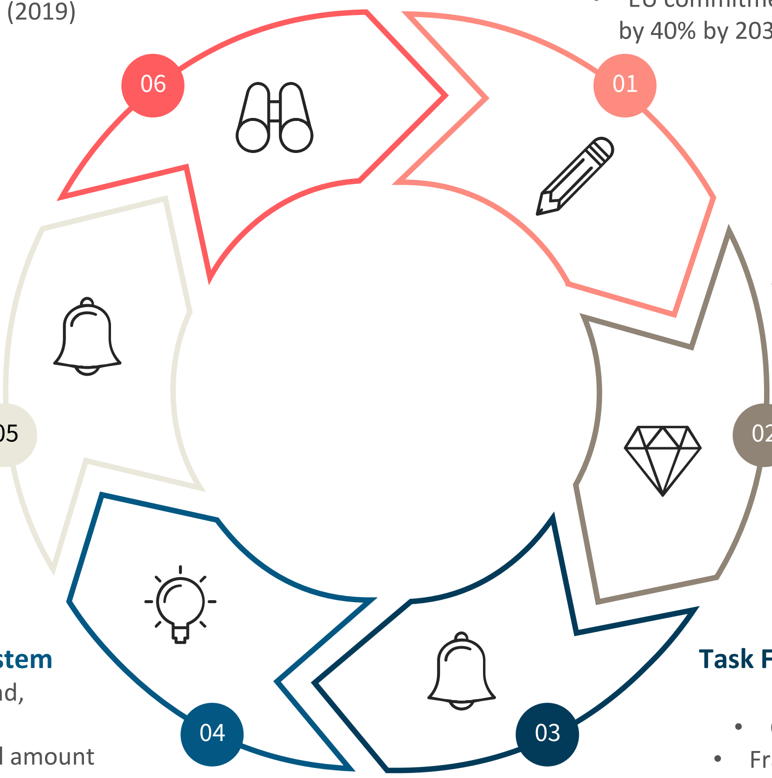
Global initiatives around sustainable finance

United Nations initiatives

- Global Compact (2005)
- Sustainable Development Goals (2015)
- Principles for Responsible Investment (2006), for Sustainable Insurance (2012), for Responsible Banking (2019)

Paris Agreement

- First universal, legally-binding global climate deal
- Adopted by 185 countries following the Conferences of Parties ("COP21") in December 2015
- EU commitments: reduce CO_2 emissions by 40% by 2030 compared to 1990 levels



UK Green Finance Strategy

- Action plan announced by the UK in July 2019
- Proposals for green finance, as part of the Clean Growth Strategy, 25 Year Environment Plan and Industrial Strategy

European Commission's Action Plan on Sustainable Finance

- Adopted in March 2018
  - Proposal for a taxonomy
  - Proposal for a regulation on disclosures
- Proposal for amending the benchmark regulation

EU Emissions Trading System

- 28 countries (EU + Iceland, Liechtenstein, Norway)
- A cap is set on the global amount of CO_2 emitted, reducing over time
- Companies can also trade allowances with one another

Task Force on Climate-related Financial Disclosures

- Created in 2015 by the FSB
- Framework for companies to develop more effective climate-related financial disclosures through their existing reporting processes

> *Ultimately, the speed which the new sustainable finance develops will be decided by the coherence and credibitlity of countries's climate policies. Finance will complement – and potentially amplify these initiatives – but it will never substitute for climate policy action.*

Mark Carney,
Governor of the Bank of England

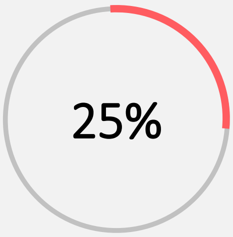
Climate Action Summit, UN General Assembly, New York, 23 September 2019

Sustainable Finance

Implementation of TCFD

In 2015, the G20 asked the Financial Stability Board ("FSB") to consider climate risk and, in the same year, the Financial Stability Board launched the Task Force on Climate-related Financial Disclosures ("TCFD") to develop voluntary, consistent climate-related financial risk disclosures for use by companies to provide information to investors, lenders, insurers, and other stakeholders. The purpose of TCFD is to help measure and respond to climate change risks and encourage corporates to align their disclosures with investors' needs.

Many companies disclose some climate-related information, but more progress is needed



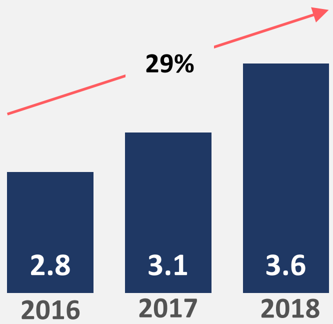
Proportion of companies now disclosing climate-related information in line with > 5 of the 11 recommended disclosures

Support for the Task Force continues to grow

5

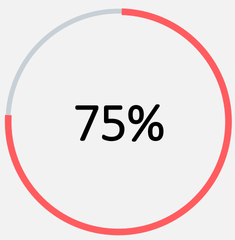
Governments supporting TCFD: Belgium, France, Sweden, the UK, and recently Canada.

The number of recommended disclosures per company has increased, but remains low



Number of recommended disclosures addressed on average by companies

The quality of disclosed information is improving



Proportion of users who cited improvements in the quality of disclosures

Source: Financial Stability Board, *Task Force on Climate-related Financial Disclosures Status Report*, 2019 – Based on an AI review of 1000+ firms' reports

The next step is to make these disclosures mandatory. Unless there is a regulatory imperative, the level of compliance achieved will vary (cf. our case study on the UK Stewardship Code on page 8). In order for TCFD to ultimately succeed, the level of government support also needs to increase. In the absence of this, investors have the power to push for greater disclosures and force change. As UN Secretary-General Antonio Guterres declared while closing the Climate Action Summit, we still 'have a long way to go'[3].

[3]Antonio Guterres, *Climate Action Summit, UN General Assembly*, New York, 23 September 2019

Sustainable Finance

Focus on: the UN Principles for Responsible Banking

So, your CEO has signed your organisation up to the UN Principles for Responsible Banking ("UNPRB"). What are the types of steps you could take to implement these?

Principle 1: Alignment

Aligning your business strategy with individuals' needs and society's goals as expressed in the Sustainable Development Goals ("SDG"), Paris Agreement, and other frameworks. We think firms could:

- Ensure your organisation has reviewed and is familiar with the SDGs and the outcomes of the Paris Agreement.
- Agree a risk appetite statement (decide whether your goal to become ESG neutral or ESG positive).
- Perform an impact assessment across your business to identify potential risk areas (e.g. project finance).
- Work with the business to identify how risks could be mitigated.
- Embed ESG factors into your new business and product approval processes.

Principle 2: Impact and target setting

Increasing your positive impacts while reducing your negative impacts, and managing the risks to people and environment arising from your activities, products, and services. We think firms could:

- Identify the areas where your organisation can have the most impact.
- Set positive targets you are looking to achieve (e.g. to reduce emissions) over a specific timeframe and stick to them.
- Assess the energy efficiency of your organisation and identify ways to enhance this (e.g. use of renewable energy, update travel policy to reduce carbon footprint, assess data centres).
- Implement the results of your impact assessment under principle 1.

Principle 3: Clients and customers

Working responsibly with clients and customers to encourage sustainable practices. We think firms could:

- Communicate your objectives to clients and assess the extent to which their objectives align.
- Provide mentorship and support to your SME clients to help them reduce their negative impacts on the environment and people.
- Perform a risk assessment of your clients to identify any clients that may have a negative impact on your sustainable finance objectives.
- Agree actions with senior management – firms may have little appetite to offboard clients who have a negative impact. However, given the current levels of public interest, firms should ensure they are able to manage reputational risks.

Principle 4: Stakeholders

Engaging with relevant stakeholders to achieve society's goals. We think firms could:

- Identify all key stakeholders (including shareholders, suppliers etc) and assess needs.
- Engage with shareholders to understand their objectives and ESG risk appetite.
- Develop an ESG policy for your supply chain, based on your ESG risk appetite.
- Similar to the Modern Slavery Act 2015, engage with your supply chain to assess their level of compliance with your ESG policy.
- Engage your employees to understand the importance they place on ESG.
- Partner with Non-Governmental Organisations to help achieve your targets.
- Discuss your ESG strategy proactively with your regulators.

Principle 5: Governance and culture

Implement your commitment to these principles through effective governance and a culture of responsible banking. We think firms could:

- Ensure there is regular reporting to the Board on compliance with sustainable finance objectives.
- Review your existing conduct and culture framework to ensure 'responsible banking' is included. Consider updating your culture framework to include sustainability.
- Create policies and train employees on 'responsible banking'.
- Embed ESG into performance management processes to ensure employees are incentivised to consider the 'ESG' in decision making.

Principle 6: Transparency and accountability

Review implementation of principles and be transparent through disclosures. We think firms could:

- Allocate responsibility to deliver compliance with the UN Principles to a Senior Management Function.
- Publish an annual report, setting out their ESG targets, an ESG-specific risk appetite statement, and assessment of their progress.
- Review current disclosures in their annual statements and ensure there is sufficient granularity.
- Work with your auditors to ensure they adequately incorporate your climate change disclosures in their work programme.

Sustainable Finance

Challenges

There seems now, more than ever, to be a genuine interest in driving forward a sustainable agenda. There is increasing pressure from investors, but also regulators. Mark Carney, the governor of the Bank of England, recently stated "Companies that don't adapt, including companies in the financial system, will go bankrupt without question"[5]. There are a number of challenges, we feel, remaining to ensure the current wave of enthusiasm translates into real action.

Definition of ESG

ESG is a broad topic and despite current work by the European Commission's Technical Expert Group on Sustainable Finance to produce a standardised taxonomy, it is inherently subjective. A taxonomy will provide firms with a baseline, but it may not provide the flexibility investors want. For example, investors will have their own judgements on whether large multi-nationals investing in renewable energy outweighs the negative impacts arising from their fossil fuel businesses. There is no right answer. There are a number of steps firms can take though.

By collecting data at its most granular level on ESG factors and preferences from clients and investors, larger firms can ensure different investor preferences are met. Smaller firms may not have the same flexibility.

Brexit

With the potential approach of Brexit, the UK should consider how it will drive ESG initiatives forward outside of the EU's Action Plan on Sustainable Finance. A number of financial institutions in the UK will need to implement the EU sustainable finance requirements for their European businesses. UK regulators should consider to what extent they are willing to implement best practices from Europe to avoid increasing complexity for firms.

Conduct

Conduct has had significant attention since the financial crisis. The definition is currently limited to the impact on customers and markets. If the banks, which have signed up to UNPRB, want to truly embed ESG principles into their culture and their business strategy, they, along with regulators, should consider extending the definition of conduct risk to include impact on the environment. The risk of reputational damage arising from poor conduct in relation to clients, markets, and the environment is similar.

Unless firms ensure ESG is embedded in the culture of the organisation and the definition of conduct risk evolves to include environmental impact, little will change.

The UK Stewardship Code

The UK Financial Reporting Council ("FRC") published the UK Stewardship Code in 2010, though it has been updated since (and is due to be revised again). The code is voluntary and relies on a 'comply or explain' approach.

- More than 300 entities signed up to the Stewardship Code in the first five years of its publication.
- The level of compliance with the code has not been consistent. The FRC noted there was a lack of evidence through disclosures to evidence that "all signatories were following through on their commitment to the Code"[4].

The FRC has taken positive action over the last few years to encourage compliance by assessing signatories and tiering them. This action has resulted in an increase in the number of asset managers in the top tier of compliance from less than 20 to 88 between 2016-17). Those firms in the bottom tier, tier 3. were threatened with being removed from the list of signatories to the code, resulting in more than 20 firms withdrawing voluntarily.

Unless a similar approach is adopted for voluntary codes and principles promoting other ESG factors, such as the UN Principles for Responsible Banking, there is a risk that many firms will sign up to the code, with very few following through on implementation. Greenwashing is a real risk and reputational impacts should be considered by firms.

[4]Financial Reporting Council, *Developments in Corporate Governance and Stewardship 2016,* January 2017
[5]The Guardian, *Capitalism is part of solution, says Mark Carney,* 31st July 2019

Sustainable Finance

Challenges

Data Availability

The market needs better disclosures from companies, as well as access to more insightful data. There are a number of initiatives, including TCFD, to help drive this forward. However, a number of challenges remain. Firstly, only five countries globally have signed up to TCFD[6], therefore global firms may be less incentivised to act. Secondly, unless countries convert these into binding requirements (e.g. as part of listing rules), compliance is difficult to enforce. Thirdly, the level of disclosures may need to be more granular to enable investment screening, catering to different ESG objectives and appetites.

Data Quality

The inherent subjectiveness of the definition of ESG could make it difficult for firms to source and use appropriate external benchmarks and data providers. Firms need to decide the data they care about. For example, consideration of governance factors can run to more than 150 variables. All firms will not want to consider all 150 variables[7]. Some of this will be driven by their clients. The ability to source data in its most granular form, rather than in already compiled and ready to use benchmarks, we think will be critical to provide firms the flexibility they need.

As ESG becomes more of a science and less of an art, companies need to ensure their disclosures are as accurate as possible and follow the same rigour as for their financial statements. Auditors will need to ensure they properly review and challenge ESG disclosures included in annual reports.

Embedding codes into regulation

Financial institutions are taking a number of positive steps to sign up to the UN principles and other voluntary codes. This is, however, voluntary. Global consistency in regulatory standards will only be achieved when there is real pressure from the G20. The FSB's TCFD is a good start, but as we have noted previously, only five countries have signed up to it. As well as pushing companies, clients need more choice and regulators should help push companies to provide this.

[6]Financial Stability Board, *TCFD Status Report*, 2019

[7]Christopher K. Merker, Sarah W. Peck, *Does the Governance of Public Pension Plans Matter?*, 20 March 2018