How US firms can navigate the EU regulatory agenda on ESG

Webinar presentation

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Agenda

- Relevance to US firms
- Addressing climate risk in banks
- Taxonomy regulation
- Conduct and disclosure reforms
- CSRD
- Diversity and inclusion

Why is the European regulatory agenda relevant to US firms?

European regulatory agenda: Key touchpoints for US firms

Key touchpoints

- Presence of European affiliates / potential for requirements to apply on a consolidated basis
- European clients (both direct clients and end-clients)
- European investors
- Impact on global standard setting
- Impact on transactions involving European stakeholders (e.g. EU syndicate banks)

Consider more generally: are there helpful standards in amongst the "noise" that US compliance / sustainability specialists can draw from in constructing or refining approach to sustainability risk

Themes

- The European policy agenda, and how regulators expect sell-side (and buy-side) firms to adapt.
- How do regulators expect European financial institutions to address and mitigate climate risk, and what can US institutions learn from this?
- Will we see UK rulemaking on ESG diverge from the EU's approach?
- Extraterritorial application of European ESG regulations: what do US firms need to know?
- Product-specific considerations

Addressing climate risk in banks

What is climate risk and why are global regulators so focused on it?

Climate-related and environmental risks are frequently expressed for regulatory purposes as comprising two main risk drivers:

- **Physical risk:** refers to the financial impact of a changing climate, including more frequent extreme weather events and gradual changes in climate, as well as of environmental degradation, such as air, water and land pollution, water stress, biodiversity loss and deforestation
    - Categorised as "acute" when it arises from extreme events, such as droughts, floods and storms, and
    - Categorised as "chronic" when it arises from progressive shifts, such as increasing temperatures, sea-level rises, water stress, biodiversity loss, land use change, habitat destruction and resource scarcity.

  Can directly result in, for example, damage to property or reduced productivity, or indirectly lead to subsequent events, such as the disruption of supply chains.

- **Transition risk:** refers to a bank's financial loss that can result, directly or indirectly, from the process of adjustment towards a lower-carbon and more environmentally sustainable economy.
    - Could be triggered by a relatively abrupt adoption of climate and environmental policies, technological progress or changes in market sentiment and preferences.

FIA

ECB guide on climate-related and environmental risks

Non-binding guidelines

Describe how the ECB expects banks to consider climate-related and environmental risks when formulating and implementing their business strategy and constructing governance and risk management frameworks.

Thirteen key principles identified by the ECB:

Risk quantification

1. Institutions are expected to understand the impact of climate-related and environmental risks on the business environment in which they operate, in the short, medium and long term, in order to be able to make informed strategic and business decisions.
2. When determining and implementing their business strategy, institutions are expected to integrate climate-related and environmental risks that impact their business environment in the short, medium or long term.

Governance

3. The management body is expected to consider climate-related and environmental risks when developing the institution's overall business strategy, business objectives and risk management framework, and to exercise effective oversight of climate-related and environmental risks.
4. Requirement to assign responsibility for the management of climate-related and environmental risks in accordance with the three lines of defence model.
5. For the purposes of internal reporting, institutions are expected to report aggregated risk data that reflects their exposure to climate-related and environmental risks with a view to enabling the management body and relevant sub-committees to make informed decisions.

ECB guide on climate-related and environmental risks

Risk management and capital adequacy

6. Explicit inclusion of climate-related and environmental risks in risk appetite framework.
7. Incorporation of climate-related and environmental risks into risk management frameworks, with a view to managing, monitoring and mitigating these over a sufficiently long-term horizon. Institutions are expected to identify and quantify these risks within their overall process of ensuring capital adequacy.
8. Requirement to consider climate-related and environmental risks at all relevant stages of the credit-granting process and to monitor the portfolio-level risk.
9. Requirement to assess whether material climate-related and environmental risks could cause net cash outflows or depletion of liquidity buffers and, if so, incorporate these factors into their liquidity risk management and liquidity buffer calibration.

Stress testing and business continuity

10. Requirement to consider how climate-related and environmental events could have an adverse impact on business continuity, plus extent to which activities could increase reputational and/or liability risks.
11. Requirement to monitor, on an ongoing basis, the effect of climate-related and environmental factors on current market risk positions and future investments, and to develop stress tests that incorporate climate-related and environmental risks.
12. Institutions with material climate-related and environmental risks are expected to evaluate the appropriateness of their stress testing with a view to incorporation into baseline and adverse scenarios.

Reporting

13. Requirement to publish meaningful information and key metrics on climate-related and environmental risks that they deem to be material.

Key points from PRA policy statement: Enhancing banks' and insurers' approaches to managing financial risks arising from climate change

Governance and interaction with the SMCR regime

- Requirement to allocate responsibility for identifying and managing financial risk arising from climate change to the relevant SMF
  - SMF to be responsible initially for ensuring there is a plan in place to address and implement the PRA's expectations
  - PRA expects to see SMF expertise develop over time
  - No Prescribed Responsibility

Risk management

- Banks required to address financial risks from climate change through their existing risk management framework
- Should be evidenced in written risk management policy, management information, and board risk reports.

Scenario analysis

- Where appropriate, banks must use scenario analysis to assess the impact of financial risks from climate change
- No specified frequency
- Scenario analysis timescales should be appropriate to the assessment of long-term risks (i.e. "in the order of decades")
  - *HOWEVER*: "it is…important that firms do not wait to initiate scenario analysis“

Disclosure

- Requirement to develop an appropriate approach to disclosure of climate-related financial risks
- Banks should recognise the increasing possibility that climate disclosures will be mandated in more jurisdictions, and prepare accordingly
- PRA is still developing its thinking on disclosure, but notes the move toward mandatory TCFD disclosure

EBA consultation on prudential disclosures on ESG risks

- **Primarily relevant to large, publicly traded European banks.**
  - BUT: may influence standards in the UK or for banks with a more limited presence. There is also a crossover with the Taxonomy Regulation via the Green Asset Ratio (GAR)
- **Proposal for banks to disclose information on exposures to sectors that significantly contribute to climate change, with a breakdown of:**
  - exposures towards fossil fuel and other carbon related sectors
  - taxonomy aligned exposures
  - information on scope 3 emissions per sector.
- **Proposed requirement to disclose quantitative information on the actions that banks are putting in place to mitigate climate change related risks, including information on taxonomy-aligned actions (GAR)**
- **Qualitative disclosures will complement this quantitative information, e.g. qualitative information on the environmental carbon reduction strategies and targets.**

EBA guidelines on loan origination and monitoring

- Guidelines intended to tackle high level of non-performing exposures.
- Objective is to improve institutions' practices and associated governance arrangements, processes and mechanisms in relation to credit granting, to ensure institutions have robust and prudent standards for credit risk taking, management and monitoring.
- Guidelines also aim to ensure that the institutions' practices are aligned with consumer protection rules and respect fair treatment of consumers
- EBA is also introducing environmentally sustainable lending dimensions, and is setting requirements for institutions to consider ESG factors, environmentally sustainable lending and associated risks in their credit policies and procedures.

ESG factors

- Institutions should take into account the risks associated with ESG factors on the financial conditions of borrowers
- Risks of climate change can primarily materialise as physical risks, such as risks to the borrower that arise from the physical effects of climate change, including liability risks for contributing to climate change, or transition risks
- Examples include risks to the borrower arising from the transition to a low-carbon and climate-resilient economy.
- Other risks may include changes in market and consumer preferences and legal risks affecting performance of underlying assets.

> Institutions should incorporate ESG factors and associated risks in their credit risk appetite and risk management policies, credit risk policies and procedures, adopting a holistic approach.

Taxonomy regulation

Obligations on companies and groups
Increased public transparency

- **Annual disclosure of the 'sustainability report' on their activities (Art. 8, Regulation (EU) 2020/852)**
    - Groups and companies are required to publish **"information on how and to what extent the undertaking's activities are associated with economic activities that qualify as environmentally sustainable"**, i.e. an alignment report.
    - The disclosure must include, at least, the **proportion of their OPEX, CAPEX and turnover that is 'sustainable'** under the EU Taxonomy. Under the draft Delegated Act for reporting (of May 10), the justification of all decisions and assessments made for each activity must be disclosed, except in 2022 when (in substance) only the share of taxonomy-eligible activities must be disclosed.
- **This will apply (most likely) to all large and nearly all listed companies.**
    - Under **current law**, only companies subject to the Non-Financial Reporting Directive, i.e. large public interest companies: **~11,000 EU companies.**
    - Commission **proposal** for "Corporate Sustainability Reporting Directive", which would expand reporting obligations to all large and nearly all listed companies, **~50,000 EU companies, and require these reports to be audited.**

Obligations on financial market actors

Taxonomy-related obligations.

1 Annual firm-level disclosure on sustainability

Like other companies, those subject to the NFRD must disclose sustainability information annually. However, their KPI (draft DA) is not turnover/CAPEX/OPEX but other indicators relating to the **share of green activities they have invested in**.

2 Changes in official 'green' labels

Any official EU or **national label, norm or standard** on sustainable investing must now refer/be **based on the EU Taxonomy.**

3 Pre-contractual and reporting-based product-level transparency

To avoid green washing, information about the **taxonomy alignment of activities in which a financial product invests must be disclosed upfront**, if (i) it actively promotes environmental characteristics, or (ii) has sustainable investment as its objective. This information must also be made available in **periodic reports**. **'Non-green' products must be clearly labelled** as having no regard for sustainability.

Fundamental principles of the EU Taxonomy
The environmental objectives and central test

An economic activity is "sustainable" if:

- It **contributes substantially** to one or more environmental objective(s).
- It does **no significant harm** to the other environmental objective(s).
- It meets the applicable "technical screening criteria."
- It complies with "minimum safeguard" (re. human and labour rights).

Art. 3, Regulation (EU) 2020/852

Six environmental objectives

I. Climate change mitigation ('complete')
II. Climate change adaptation ('complete')
III. The sustainable use and protection of water and marine resources (incomplete)
IV. The transition to a circular economy (incomplete)
V. Pollution prevention and control (incomplete)
VI. The protection and restoration of biodiversity and ecosystems (incomplete)

Art. 9, Regulation (EU) 2020/852

The application of the EU taxonomy: A guide

How to determine whether an economic activity is sustainable?

Look through the Commission's list in the Delegated Act.

Assess the technical criteria for substantial contribution and DNSH

Ensure compliance with labor and human rights ('minimum safeguards')

SUSTAINABLE

Conduct and disclosure reforms

The EU SFDR: Required disclosures

- **FMPs and financial advisers are required to post the following on their websites (Art. 4 Regulation (EU) 2019/2088):**
  - policies on their approach to sustainability;
  - data on whether, and if so how, they have regard to the "principal adverse impacts" on either; (i) sustainability of investment decisions for FMIs, or (ii) investment advice for investment advisers; and
  - how the firm's remuneration policies are consistent with the integration of sustainability risks.
- **FMPs and Financial Advisers must include the following in their pre-contractual disclosures (Art. 6 Regulation (EU) 2019/2088):**
  - the manner in which sustainability risks have been integrated into the firm's investment decisions, investment advice or insurance advice, as applicable; and
  - the likely impact on the returns of financial products made available or advised upon by the firm.

The EU SFDR: Required disclosures cont.

- **Other points to note:**
  - If firms state that disclosures are "not relevant", they will need to provide a clear explanation of why this is the case. However, please note that the regulatory thresholds for "relevance" have yet to be made clear.
  - The reference to remuneration policies is consistent with an increasing trend towards the use of remuneration to promote the need for a compliance culture more generally within firms.
  - FMPs that consider the principal adverse impacts of their investment decisions on sustainability factors must make certain additional pre-contractual disclosures.
  - Although there is an ability to opt of this disclosure standard by simply stating that the FMP has not considered the adverse impacts of investment decisions on sustainability and why this is the case, the ability for FMPs to make use of this exemption may be somewhat limited in practice.

The SFDR – who does it apply to?

New Regime

- The required disclosures will need to summarise the integration of sustainability risks into the firm's investment decision making processes, investment advice or insurance advice, as relevant. This requirement will largely apply to banks that provide either advice or portfolio asset management services.
- Recital 7 clarifies that the entities covered, depending on the nature of their activities, should comply with the rules on financial market participants where they manufacture financial products, and with the rules on financial advisers where they provide investment or insurance advice.

Financial Market Participants

- The Art. 2 definition covers:
  - **banks and investment firms that provide portfolio management services;**
  - undertakings that make IBIPs available;
  - AIFMs;
  - UCITS ManCos;
  - institutions for occupational retirement provision; and
  - pension product manufacturers.

Financial Advisers

- The Art. 2 definition covers:
  - **banks that provide investment advice;**
  - investment firms providing investment advice;
  - AIFMs;
  - UCITS ManCos;
  - insurance firms that provide advice on IBIPS.

MiFID II reforms

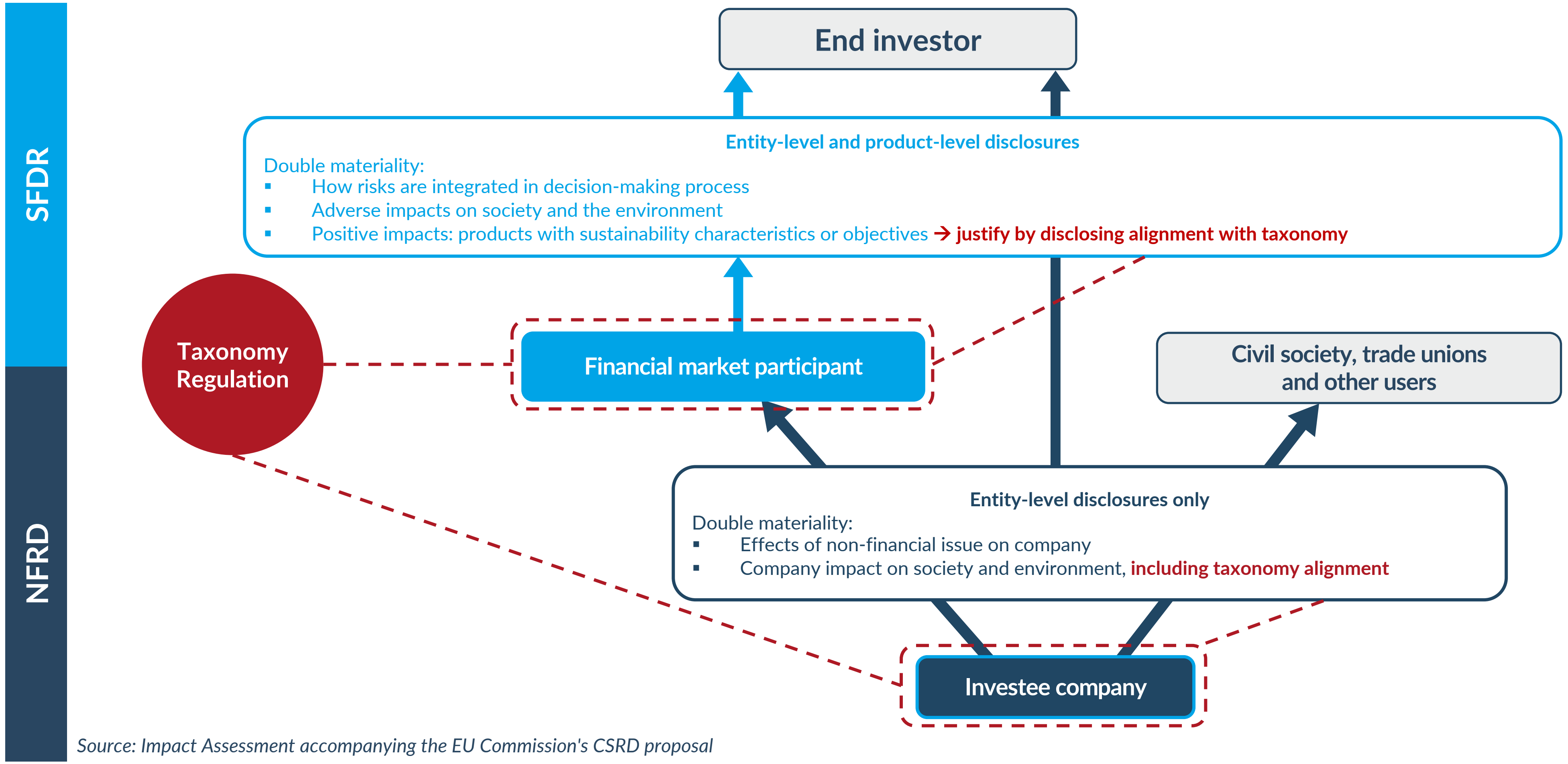
- **Product governance**
  - Introduction of a new definition of "sustainability preferences" into the MiFiD II Delegated Directive
  - The assessment of the target market for investment products and services distributed in the EU will in future need to incorporate an assessment of "any sustainability preferences" amongst end clients and investors
  - Firms will need to ensure that investments remain consistent with the needs, characteristics and objectives of the target market, including any sustainability preferences
  - If a firm identifies an inconsistency between a product and its target market, the firm should reconsider if the target market and/or product governance arrangements are suitable for the relevant product
- **Conflicts of interest**
  - When identifying conflicts of interest that may damage the interests of a client, banks will need to include conflicts that may stem from sustainability considerations and sustainability risks
- **Risk management**
  - Sustainability risks should be considered when identifying risks facing the bank and setting its risk tolerance limits
- **Suitability**
  - Requirement to take suitability preferences into account when performing suitability checks

Other UK-specific developments affecting banks

- Confirmation of move towards mandatory TCFD reporting
- Requirement for FCA to interpret its objectives in light of the Climate Change Act
- FCA recent hire of Sacha Sadan
- COP26 and the UK's "green industrial revolution"
- Bank of England set to launch its first climate-related stress test of banks and insurers in June to assess business model changes

CSRD

Interaction between NFRD, SFDR and taxonomy regulation



Source: Impact Assessment accompanying the EU Commission's CSRD proposal

CSRD: Key amendments to the NFRD regime

- Extends scope of reporting requirements to include all large companies and listed companies (except listed micro-companies), including banks and insurance companies meeting size criteria
- Requires assurance (e.g. audit) of sustainability information
- Specifies in more detail the information that companies should report, and requires them to report in line with mandatory EU sustainability reporting standards
- Requires that all information is published as part of companies' management reports, and disclosed in a digital, machine-readable format

CSRD: Reporting requirements

Information to be reported:

- Business model and strategy
- Sustainability targets and progress towards achieving those targets
- Role of management and supervisory bodies with regard to sustainability matters
- Policies on sustainability matters
- A description of implemented due diligence process on sustainability matters
- Principal actual and potential adverse impacts on the company’s value chain and actions to mitigate or remedy impacts
- Principal risks on sustainability matters
- Indicators relevant to the disclosures

Extending to:

- Business relationships
- Global supply chains
- Environmental factors e.g. climate change adaption and mitigation, etc.
- Social factors e.g. gender equality and equal pay for equal work, forced and child labour, consistent with international standards, etc.
- Governance factors e.g. business ethics and corporate culture, lobbying, internal control and risk management, etc.

EU Commission to set mandatory sustainability disclosure standards in delegated acts, taking into account Taxonomy Regulation, SFDR and other EU measures, global standard-setting initiatives – should result in harmonised alignment

CSRD: Indicative timing

H1 2022

Possible political agreement on CSRD

By mid 2022

EFRAG advice on sustainability standards

By Oct 2022

First set of sustainability standards to be adopted

By end 2022

Commission to adopt first set of reporting standards (subject to finalisation)

2024

Affected companies to apply standards for the first time to reports published in 2024 for FY2023 (subject to finalisation)

Diversity and inclusion

Overview

- D&I has moved to the forefront of the supervisory agenda
- Particularly relevant in light of the disproportionate impact that the COVID-19 pandemic has had on ethnic minorities and women in many parts of the world and the intensification of prominent social movements, such as Black Lives Matter
- Recent publication of extensive FCA paper on D&I
- D&I is also a key component of the social pillar of ESG
- Stakeholders as well as regulators have been paying attention to the corporate response in this area
- How focused compliance leaders are on D&I is a litmus test for how far these considerations have moved from a "nice-to-have" to a "need-to-have"

> Ultimately, we want firms to take action to embed diverse and inclusive cultures, so they can realise the benefits within their organisations.
>
> \- FCA

Potential sixth conduct question for senior managers

Is your management team diverse enough to provide adequate challenge and do you create the right environment in which people of all backgrounds can speak up?

This is much broader than representation. It is about a firm's culture. Not just in relation to diversity, but inclusion, too. Do people feel comfortable in the work environment such that they can demonstrate, share and bring to bear their diversity of experience and background?

Thank you to our presenter!

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