CLIFFORD CHANCE

SUSTAINABLE FINANCE
THE IMPACT FOR BANKS AND INVESTMENT FIRMS

GROWING THE GREEN ECONOMY

NOVEMBER 2019

SUSTAINABLE FINANCE
THE IMPACT FOR BANKS AND INVESTMENT FIRMS

The focus of financial markets regulators and central banks is increasingly falling on climate change and the green economy, and in particular the resilience of the financial system to climate-related risks.

Regulators in both the UK and EU have turned their attention to environmental, social and governance (**ESG**) factors and their impact on banks' business, focusing on three key areas:

- disclosure by issuers, product manufacturers and distributors of information on the ESG credentials of companies and products;
- requiring firms giving advice or making investment decisions to have policies around ESG factors and to disclose additional information to clients; and
- requiring banks and investment firms to assess their exposures to ESG-related financial risks (with the UK Prudential Regulation Authority having required firms to report on these exposures by 15 October 2019).

The EU proposals in particular are being implemented not just by way of new legislation; but also by way of amendments to or guidance under existing legislation. As a result, banks and investment firms will need a process for monitoring these changes and identifying the provisions that are relevant to their business as well as ensuring that they have allocated responsibility internally for compliance with these obligations.

Many of the EU proposals require additional disclosures to be published or pre-contractual information to be provided to clients. Increased disclosure and enhanced transparency on ESG risks is also a focus of international standard setting bodies, including the FSB's Task Force on Climate-related Financial Disclosures and IOSCO, which recently published a report on sustainable finance in emerging markets recommending reporting and disclosure of material ESG risks.

As these disclosure, reporting and risk management requirements increase and cover multiple jurisdictions, firms will increasingly need a centralised process that brings together different business lines and geographies in order to identify, quantify, monitor and manage ESG risks across their global business as well as a process for drafting and updating disclosures to make sure that their message is consistent and that they record and verify the sources of any published information.

The UK's sustainable finance agenda

In common with central banks and financial services regulators in other jurisdictions, the UK regulators have expressed their concerns about the potential impact of climate change on the financial sector and the role that financial services firms have to play in tackling climate change. The Prudential Regulation Authority (**PRA**) and Financial Conduct Authority (**FCA**) have formed a joint Climate Financial Risk Forum; which brings together senior representatives from across the financial sector to advance financial sector responses to financial risks from climate change, and in July 2019 the PRA, FCA, Financial Reporting Council and The Pensions Regulator published a joint statement on climate change, welcoming the launch of the UK Government's Green Finance Strategy.

The PRA and FCA have both recently published papers setting out in more detail their proposals and expectations for both regulated and listed firms in relation to climate change. The requirements of the UK regulators in relation to ESG factors reflect their statutory objectives, with the PRA and Bank of England focusing on prudential risks, while the FCA is focused on services provided to clients and internal governance.

"As financial policymakers and prudential supervisors we cannot ignore the obvious physical risks before our eyes. Climate change is a global problem, which requires global solutions, in which the whole financial sector has a central role to play"

– Mark Carney and François Villeroy de Galhau, April 2019

The PRA's expectations for insurers, banks and PRA-regulated investment firms

The PRA published its Policy Statement "'Enhancing banks' and insurers' approaches to managing the financial risks from climate change" in April 2019, with an accompanying supervisory statement (SS3/19) which sets out further detail on the PRA's expectations.

The PRA expected firms to have formulated an initial plan to address these expectations by 15 October 2019 and to have submitted an updated Senior Management Function form by that date.

The PRA considers that climate-related financial risks present unique challenges and require a strategic approach to financial risk management. In particular, the PRA describes two key risk factors through which financial risks from climate change are expected to arise:

- Physical risks (i.e., risks relating to specific weather events or longer-term shifts in the climate, which may then impact the value of assets or collateral held by banks); and
- Transition risks (i.e., risks which arise from adjustment to a low-carbon economy, including climate-related developments in policy and regulation, emerging disruptive technology and changing public sentiment and societal preferences, affecting banks' lending portfolios or the value of financial assets in affected sectors).

While a firm's approach to managing financial risks from climate change is likely to evolve over time, the PRA expected the initial response to address at least the following:

- **Governance**: A firm's board should understand and be able to assess the financial risks from climate change that affect the firm, taking a sufficiently long-term view of the financial risks that can arise beyond standard business planning horizons. Firms should have clear roles and responsibilities for the board and relevant committees in managing the financial risks from climate change. In particular; the board should identify the Senior Management Functions (**SMF**) with responsibility for identifying and managing financial risks from climate change and ensure that this responsibility is included in the SMF's Statement of Responsibilities.

- **Risk management**: Firms should identify, measure, monitor, manage and report on their exposure to financial risks from climate change, in line with their existing risk management frameworks. In particular, a firm's Internal Capital Adequacy Assessment Process (**ICAAP**) should address material exposures relating to financial risks from climate change.
- **Scenario analysis**: Firms should conduct appropriate scenario analysis to inform their strategic planning and determine the impact of financial risks from climate change on their overall risk profile and business strategy. The PRA expects this analysis to evolve and mature over time, but the initial analysis should cover both a short-term assessment as well as a longer-term assessment looking over a period of decades.
- **Disclosure**: Banks are already required to disclose information on material risks within their Pillar 3 disclosures. They should consider whether further disclosures are necessary to address material risks associated with climate change, and also to indicate how climate-related financial risks are integrated into their governance and risk-management processes. The PRA expects that these disclosures should evolve to be as insightful as possible, and also that firms should prepare for the increasing possibility that disclosures of this sort will be mandated in other jurisdictions.

The FCA's expectations for FCA regulated firms and UK issuers
The FCA has also published a feedback paper to its discussion paper on climate change and green finance in October 2019, setting out its proposed approach to address the potential impacts on UK markets.

In the Feedback Statement, the FCA outlined the following four priority action areas that will provide a foundation for the FCA's future work on climate change and green finance:

- **Climate change disclosures by issuers**: The FCA intends to publish a consultation paper in early 2020 proposing new disclosure rules for certain issuers aligned with the TCFD's recommendations on a 'comply or explain' basis and clarifying existing disclosure obligations relating to climate change risks.
- **Regulated firms' integration of climate change risk**: The FCA intends to finalise proposed rule changes to require Independent Governance Committees to oversee and report on firms' ESG policies and to facilitate investment in patient capital. The FCA also signalled its continued supervisory and policy interest in stewardship and FCA published a feedback statement to its joint discussion paper with the Financial Reporting Council (FRC) on stewardship on 24 October 2019, alongside the FRC's publication of the new UK Stewardship Code 2020. The FCA indicated that it intends to continue working with industry, the FRC, Government and other regulators to help address remaining barriers to effective stewardship and will consider the need for further action in this area as the UK Stewardship Code 2020 takes effect from 1 January 2020.
- **Regulatory expectations around green financial products and services**: The FCA intends to challenge potential greenwashing, clarify expectations and take appropriate action to prevent consumers being misled, carry out further policy analysis and issue guidance to address concerns on greenwashing and engage with

the proposals of the EU Sustainable Finance Action Plan, particularly around common standards and product disclosures.

- **Collaboration with Government, other regulators and industry**: The FCA will continue to participate in collaborative initiatives such as the Climate Financial Risk Forum, the Fair and Effective Markets Review (FEMR) working group and the EU Sustainable Finance Action Plan and support the UK Green Finance Strategy through its membership of the Government led cross-regulator taskforce on disclosure.

For more details about the FCA's Feedback Statement, see our recent briefing "Sustainability Snapshot: UK FCA signals next steps in its strategy on climate change and green finance".

The EU Sustainable Finance Action Plan and other recent developments

The EU has adopted, or is in the process of adopting, a number of pieces of financial services legislation which address different aspects of the EU Sustainable Finance Action Plan. These cover a wide range of business areas and product types, and firms will need a process for monitoring these developments and mapping them against their business to ensure that they are compliant. The proposals include:

- **Obligations for benchmark administrators**: The low carbon benchmarks regulation will require all benchmark administrators to include, in their benchmark statements, an explanation of how ESG factors are reflected in each benchmark or family of benchmarks. If the benchmark does not pursue ESG objectives, the benchmark administrator should state this in the benchmark statement.

  The European Commission's Technical Expert Group (**TEG**) has also published detailed recommendations on ESG disclosures in benchmarks which build on the requirements of the low-carbon benchmarks regulation and propose minimum content requirements and templates for both the benchmark methodology and for the benchmark statement.

- **Requirements for investment firms providing advice or portfolio management services**: The sustainable finance disclosure regulation will require firms which make investment decisions or give investment advice to publish information on their website regarding their policies on integration of sustainability risks in their investment decision-making process. The revised shareholder rights directive imposes further disclosure obligations, including a requirement for institutional investors and asset managers (including investment firms providing investment advice or portfolio management) to make public disclosure of their policies on shareholder engagement and monitoring of investee companies on relevant matters; including social and environmental impact and corporate governance, and for asset managers to give information to institutional investors to enable them to assess whether the asset manager acts in the best long-term interests of the investor.

  Changes to guidelines under MiFID2 will also require firms to take their clients' preferences on ESG risks and factors into account when complying with the MiFID2 suitability requirements; and to include information on ESG risks in pre-contractual information and periodic statements to clients.

- **Product governance requirements for manufacturers and distributors**: Amended MiFID2 delegated acts and guidelines will require investment firms; which manufacture or distribute products; to take sustainability when assessing the target market for products.

- **Prudential and organisational requirements for investment firms and banks**: Amendments to the MiFID2 delegated acts will require investment firms to integrate sustainability risks into their compliance with the general organisational requirements under MiFID2, including in their risk management systems and procedures and when identifying conflicts of interest. The revised shareholder rights directive also requires the performance of EU company directors to be assessed in relation to both financial and non-financial performance criteria, including ESG factors where appropriate.
- **Other disclosure requirements**: The proposed Regulation establishing a framework to facilitate sustainable investment is expected to require financial market participants to make further disclosure of relevant information, allowing investors to establish whether the products they offer qualify as environmentally sustainable investments.

The European Securities and Markets Authority (**ESMA**) also published a questionnaire aimed at gathering evidence on short-term pressures on corporations stemming from the financial sector. The European Commission has mandated ESMA and the other ESAs to gather and report on this evidence, as the Commission is concerned that companies focus on near-term performance at the expense of mid- to long-term objectives, including innovation and human capital, and that they may overlook environmental and social objectives.

ESMA's questionnaire focuses in particular on:

- Investment strategy and investment horizon;
- Disclosure of ESG factors and the contribution of such disclosure to long-term investment strategies;
- The role of fair value in better investment decision-making;
- Institutional investors' engagement;
- Remuneration of fund managers and corporate executives; and
- Use of CDS by investment funds (and in particular whether sell-only or net sell CDS positions may indicate increased short-term risk taking by funds).

Many of these issues are already addressed to some degree in the legislation discussed above, although ESMA's report may result in further changes.

ESMA will report to the Commission by December 2019, presenting its evidence and findings and potentially advising on steps to address any undue short-termism. The Commission will consider ways to follow up on the report's findings.

For the latest on the EU Sustainable Finance Action Plan, see our recent briefing "The EU Sustainable Action Plan - Status Table: Progress and Next Steps"

CLIFFORD
CHANCE

CONTACTS

Caroline Dawson
Partner
T: +44 20 7006 4355
E: caroline.dawson@
cliffordchance.com

Laura Douglas
Senior Associate
T: +44 20 7006 1113
E: laura.douglas@
cliffordchance.com

Stephanie Peacock
Senior Associate
T: +44 20 7006 4387
E: stephanie.peacock@
cliffordchance.com

GROWING THE GREEN ECONOMY

This article was initially published in **GROWING THE GREEN ECONOMY:** ADDRESSING THE SUSTAINABILITY CHALLENGES AND OPPORTUNITIES, our far-reaching look at developments in ESG and sustainable finance.

The severe warnings on climate change starkly documented by the IPCC report and others demonstrate why urgent action to meet the goals of the Paris Agreement is needed. The public, governments and legislators are taking notice and taking action. Much of the legislative effort to date has been focused on the financial system but there is an increasing emphasis on non-financial entities and the requirements that are beginning to be expected of them. These requirements stem from legislation, public pressure and possible litigation.

GROWING THE GREEN ECONOMY reflects the breadth and depth of the impact of these environmental and sustainable factors. **Visit www.cliffordchance.com/greeneconomy** to read and download the publication in full.

C L I F F O R D
C H A N C E

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571
Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications.

Abu Dhabi • Amsterdam • Barcelona
Beijing • Brussels • Bucharest
Casablanca • Dubai • Düsseldorf
Frankfurt • Hong Kong • Istanbul
London • Luxembourg • Madrid
Milan • Moscow • Munich • Newcastle
New York • Paris • Perth • Prague
Rome • São Paulo • Seoul • Shanghai
Singapore • Sydney • Tokyo • Warsaw
Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

FSC
www.fsc.org
RECYCLED
Paper made from recycled material
FSC® C012830

1911-000008