fieldfisher

ESG in finance

Adopting changes in the financial system to support a just transition

Introduction

by Alan J Somerville, Governex Limited

www.governexgroup.com

Environment, sustainability and governance is back on the agenda.

The recent US election result will have greater impact on the global sustainability agenda than we perhaps anticipate. Looking at both the political agenda of the new US administration and the early political appointees, one thing is clear, ESG will be central to corporate agendas in the coming years.

Speaking at the Green Summit in November 2020 the UK's Chancellor of the Exchequer, Rishi Sunak made a number of major announcements on green finance, confirming that the UK will issue its first – and by no means its last – green gilts in 2021 and will introduce new climate disclosure requirements. These announcements form part of 'The Ten Point Plan for a Green Industrial Revolution'.

To ensure that the government appropriately allocates funding raised through the bond, the Treasury is to implement a green finance taxonomy, similar to that under development by the EU. The taxonomy mandates those activities can be defined as 'green' and is aligned with the UK's long-term climate targets. This definition by UK government is welcomed and will help create consistency across the Green Finance market place.

The convening of a new UK Green Technical Advisory Group who will create and implement the taxonomy further buoys the Treasury's commitment to help to fund projects directed at tackling climate change, financing much-needed infrastructure and investment and creating green jobs across the country.

During the same summit, the Financial Conduct Authority (FCA) outlined stricter rules on climate risk reporting in line with the recommendations of the global Taskforce on Climate-related Financial Disclosures (TCFD).

From 2023, all publicly listed UK companies with a premium listing will be required to 'comply or explain' against the TCFD's requirements. Subject to consultation, the intention is to tighten and extend the rules further in 2025.

Vast swathes of the UK's finance industry will be subject to these new requirements, including major pension schemes, life insurance providers and asset managers according to Mr Sunak.

Coupled with recent legislation with ESG changes to be implemented and current consultations where ESG changes are under discussion, the landscape for the entire financial services sector is fast changing.

These multi-faceted changes have major implications for investors, lenders and borrowers as they seek to navigate the legislative, regulatory and stakeholder requirements around their approach to environment, social and governance concerns.

As a starting point, those firms operating in the financial sector need to determine whether their strategy relies on complying, or performing. The outcomes for each are very different and will affect their approach to ESG in very different ways.

This paper explores to origins of ESG, the current changes and consultations underway and highlights areas where Fieldfisher can provide guidance and support to banks and other financial institutions on the regulatory and legislative changes that will impose ESG requirements on their business.

"The absence of a generally accepted international framework for the reporting of material aspects of ESG and other relevant considerations for long-term value creation contrasts with the well established standards that exist for reporting and verifying financial performance. The existence of multiple ESG measurement and reporting frameworks and lack of consistency and comparability of metrics were defined as pain points that hinder the ability of companies to meaningfully and credibly demonstrate the progress they are making on sustainability, including their contribution to the SDGs."

WEF: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation

ESG in finance
Summary

Across Europe, governments are introducing ambitious targets to encourage society to adopt environmental, social and governance (ESG) measures, principally to transition to a low carbon economy.

The UK (England, Wales and Northern Ireland) has established a legally binding commitment to deliver net-zero greenhouse gas emissions by 2050 with Scotland's target being five years earlier in 2045. Post-covid (and post-Brexit) Government policy is already gearing up to drive a green economy and together with an increasing emphasis on sustainability, businesses are making material changes to how they operate and ultimately on how they are measured and valued by their stakeholders in the future.

While organisations are auditing and adopting operational measures to improve ESG standards and practices, ESG in finance is at a very nascent stage of development. Until recently, there has been nothing to compel anyone in the financial sector to apply ESG standards to financial transactions, as there are currently no common standards for the financial sector to abide by.

This is due to change and this paper looks at the background to ESG principles and some of the changes that are currently under consultation related to ESG in finance.

Quantifying corporate sustainability

ESG is not new, the concept of being a 'good corporate citizen' and embracing sustainable practices has been around for a number of decades.

For many years, the challenge of how to measure and report corporate social good deeds has been a blocker on setting ESG standards. The issue was not just how to measure and report, but also how to compare. While there was a need for common standards that organisations could measure against, there was also a need for their stakeholders to be able to make a comparison against their peers.

Being able to measure and rank corporate sustainability was established by independent organisations like the Global Reporting Index (GRI) whose Sustainability Reporting Standards (GRI Standards) were the first and most widely adopted global standards for sustainability reporting. GRI pioneered sustainability reporting in the late 1990s, transforming it from a niche practice into one now adopted by a growing majority of organisations.

According to a KPMG Survey of Corporate Responsibility Reporting in 2017, 93% of the world's largest 250 corporations used GRI Standards to report on their sustainability.

The concept of ESG investing goes back to 2004 when former UN Secretary General Kofi Annan invited over 50 CEOs of major financial institutions to participate in a joint initiative under the auspices of the UN Global Compact and with the support of the International Finance Corporation (IFC) and the Swiss Government.

The goal of the joint initiative was to develop guidelines and recommendations on how to better integrate ESG issues in asset management, securities brokerage services and associated research functions.

The resulting report, 'Who Cares Wins' made the case that embedding ESG factors in capital markets makes good business sense and leads to more sustainable markets and better outcomes for societies.

A year later, the United Nations Environment Programme Finance Initiative (UNEP FI), a partnership between UNEP and the global financial sector, produced the 'Freshfield Report' which showed that ESG issues are relevant for financial valuation. These two reports formed the backbone for the launch of the Principles for Responsible Investment (PRI) at the New York Stock Exchange in 2006 and the launch of the Sustainable Stock Exchange Initiative (SSEI) the following year.

Quantifying corporate sustainability continued

Principles for Responsible Investment (source: https://www.unpri.org/pri)

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice.

The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. They have attracted a global signatory base representing a majority of the world's professionally managed investments.

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

Principle 6: We will each report on our activities and progress towards implementing the Principles.

The UN gave the corporate sustainability issue further direction in 2015, when it issued its Sustainable Development Goals (SDG). According to the UN, they address global challenges including those related to poverty, inequality, climate change, environmental degradation, peace and justice. The 17 Goals are all interconnected and the UN has an ambitious target to achieve them all by 2030. In order to achieve this target though, it is critical that the world of commerce and industry finds ways to embrace and deliver on the goals' principles.

The International Organization for Standardization (ISO) already directly addresses the economic, environmental and societal dimensions of the UN SDG within its standards. Organisations and companies looking to contribute to the SDGs will find that International Standards provide effective tools to help them rise to the challenge.

For investors, organisations like the International Capital Markets Association use the SDGs to provide a broad frame of reference by which issuers, investors and bond market participants can evaluate the financing objectives of a given Green, Social or Sustainability Bond Programme against the UN Sustainable Development Goals.

In May 2020, global loan market associations launch new guidance documents to support the Green Loan Principles and the Sustainability Linked Loan Principles.

Quantifying corporate sustainability continued

Green Loan Principles

The fundamental determinant of a green loan is the utilisation of the loan proceeds for Green Projects (including other related and supporting expenditures, including R&D), which should be appropriately described in the finance documents and, if applicable, marketing materials. All designated Green Projects should provide clear environmental benefits, which will be assessed, and where feasible, quantified, measured and reported by the borrower.

Sustainability Linked Loan Principles

Sustainability linked loans are any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives. The borrower's sustainability performance is measured using sustainability performance targets (SPTs), as set against key performance indicators, external ratings and/or equivalent metrics and which measure improvements in the borrower's sustainability profile.

Source: Loan Market Association

The guidance documents received input from each association's respective green and sustainable finance working party, each of which consists of representatives from leading financial institutions and law firms across the globe and aims to find a globally acceptable approach to the granting of green and sustainability linked loan products.

While broader legislation to address environmental and sustainability issues has been gathering pace, finance has largely avoided direct scrutiny or ESG legislation. Until now, there has been nothing to compel anyone in the financial sector to apply ESG standards to financial transactions, as there were no common legislative standards for the financial sector to abide by.

Several factors influence investment decisions, but those related to environmental and social considerations are often not adequately taken into account as the risks tend to materialise over a longer time period.

ESG in finance or 'sustainable finance', generally refers to the process of undertaking due diligence in environmental and social considerations related to investment decision-making. However, there is increasing interest in ESG from all market participants and not just those seeking funding as ESG issues pose risks to the financial system.

In identifying these risks, NGOs, central banks and financial regulators can contribute to the development of frameworks and modelling tools for assessing climate-related financial risks.

ESG in finance

UN-PRI and a group of banks from all continents are cooperating on building up principles for responsible banking, though these are likely to be similar to its investment principles, in that they will be voluntary and aspirational. There is currently no global benchmark to assess how 'green' a financial product is.

Recognising the need for common legal standards to reflect public and institutional sentiment towards ESG, particularly for those operating in regulated sectors such as finance, the EU has begun to develop some ESG-specific and some ESG-relevant legislation. The point of the legislation is to develop benchmarks and eradicate so-called 'greenwashing'.

Over the next decades, climate change is likely to transform economies in a fundamental way. Elected governments are primarily responsible for managing the transition to a low-carbon economy. Yet central banks and financial regulators cannot ignore the potentially serious risks that climate change poses to the financial system. Understanding and addressing these risks is a major task and more research in this area is necessary to inform policy development in all areas, including financial policy, to support sa smooth but timely transition.

The EU is already providing impetus to help attract the required investments with the European Fund for Strategic Investments and other initiatives. However, the scale of the investment challenge is beyond the capacity of the public sector alone. The financial sector has a key role to play in reaching those goals.

It can redirect investments towards more sustainable technologies and businesses, finance growth in a sustainable manner over the long-term and contribute to the creation of a low-carbon, climate resilient and circular economy.

Recent legislation: ESG changes to be implemented

The following subjects have been legislated and are coming into force in the coming months/years (as applicable):

Subject	EU/UK	Subject entities/products	Summary
Disclosure	EU – Regulation 2019/2088	AIFMs and UCITS management companies Investment firms carrying out portfolio management Financial advisers	In scope entities will be required to provide investors with certain ESG-related information for financial products in order to enable investors make informed investment decisions based on ESG factors.
Benchmarks	EU – Regulation (EU) 2019/2089 amending Regulation (EU) 2016/1011	Benchmark administrators	Two new types of 'climate benchmarks' have been introduced. In the benchmark statement of each benchmark or family of benchmarks, the administrator must include an explanation of how ESG factors are reflected in that benchmark or benchmark family. Minimum requirements have also been laid down for EU climate transition benchmarks and EU Paris-aligned benchmarks, to ensure that these benchmarks do not significantly harm other ESG objectives.
Treatment of investments	EU – Regulation (EU) 2020/852 amending Regulation (EU) 2019/2088	Financial market participants	The regulation introduces an EU-wide classification framework to enable entities to identify which economic activities and investments can be treated as 'environmentally sustainable'.

Current consultations: ESG changes under discussion

The following subjects are under consultation with a view to legislation being enacted in the near term:

Subject	EU/UK	Subject entities/products	Timeline
Disclosure	UK	Listed issuers Issuers with securities admitted to trading on regulated markets Other entities in scope of requirements under the Market Abuse Regulation (MAR) and the Prospectus Regulation (PR)	**Consultation phase** Consultation closed on 1 October 2020 with the planned implementation to be in 2021. (CP20/3).
Pillar 3 Disclosures	EU	Large institutions (under Article 449a CRR)	**Survey phase** The survey closed on 16 October 2020.
UK emissions trading scheme/carbon emissions tax	EU	Companies in the industry	Following Brexit.
Prioritisation of short-term performance over long-term objectives	EU	Securities market participants	None specified but part of the EU's wider work on sustainable finance and relates to the European Commission's Action Plan on 'Financing Sustainable Growth'.

EU Taxonomy Regulation

In March 2018, the European Commission unveiled a cache of regulations as part of its action plan on sustainable finance, which require financial market participants and advisers to comply with certain standards when making decisions and dispensing advice on corporate ESG performance.

The Commission intends to clarify how asset managers, insurance companies, and investment or insurance advisors should integrate sustainability risks and, where relevant, other sustainability factors in the areas of organisational requirements, operating conditions, risk management and target market assessment.

The Commission set up a technical expert group on sustainable finance (TEG) to assist it notably in the development of a unified classification system for sustainable economic activities, an EU green bond standard, methodologies for low-carbon indices, and metrics for climate-related disclosure.

EU commission vice-president Valdis Dombrovskis has called the taxonomy the *"single most important piece of legislation"* aimed at the markets that can help governments meet global emission targets.

Article 20 of the Taxonomy Regulation creates a 'platform on sustainable finance'. The platform will be an advisory body composed of experts from the private and public sector. This group of experts will advise the Commission on the technical screening criteria for the EU Taxonomy and sustainable finance more broadly. In addition, the platform will monitor and report on capital flows towards sustainable investments.

European Green Deal and Renewed Sustainable Finance Strategy

On 11 December 2019, the Commission presented the European Green Deal, a growth strategy aiming to make Europe the first climate neutral continent by 2050. As part of the Green Deal, on the Commission presented on 14 January 2020 the European Green Deal Investment Plan, which will mobilise at least €1 trillion of sustainable investments over the next decade. It will enable a framework to facilitate public and private investments needed for the transition to a climate-neutral, green, competitive and inclusive economy.

The European Green Deal and the recovery from the economic consequences of the covid-19 crisis will significantly increase the investment efforts needed across all sectors, meaning that financing frameworks, both public and private, must support this overall policy direction.

This is why the European Green Deal has announced a Renewed Sustainable Finance Strategy, which aims to provide the policy tools to ensure that the financial systems genuinely support the transition of businesses towards sustainability in a context of recovery.

Building on the 2018 Action Plan on financing sustainable growth, the renewed sustainable finance strategy will provide a roadmap with new actions to increase private investment in sustainable projects and activities to support the different actions set out in the European Green Deal.

The initiative will also manage and integrate climate and environmental risks into the EU financial system and will build on previous initiatives and reports, such as the Commission's 2018 Action Plan on Financing Sustainable Growth and the reports of the Technical Expert Group on Sustainable Finance (TEG).

The ongoing covid-19 crisis highlighted the importance of a Renewed Sustainable Finance Strategy, underscoring some of the subtle links and risks associated with human activity, climate change, and biodiversity loss, as well as the subsequently critical need to strengthen the sustainability and resilience of our societies and economies.

Finance for a more sustainable world

The EU's Action Plan for Financing Sustainable Growth aims to:

1. reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
2. manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
3. foster transparency and long-termism in financial and economic activity.

The new regulation requiring firms to disclose the environmental impacts of investment decisions, requiring advisers to seek clients' preferences on ESG factors, and the legal basis of the EU's taxonomy will all come into force in law after the end of 2020.

ESG in finance continued

Other ESG Reform Projects underway in the EU include:

- Improving disclosure of information by large companies about their social and environmental practices and results.
- The development of criteria for the EU Ecolabel for Financial Products and the definition of the minimum environmental performance of this product group.
- Building on recommendations of the TEG, formulating an EU Green Bond Standard (EU GBS).
- Integration of ESG risks and factors into prudential bank regulation as well as guidance on the management of climate-related and environmental risks and the consideration of ESG factors in loan origination and monitoring.
- Potential measures against undue pressure from the financial sector on corporations to prioritise short-term performance over long-term objectives including ESG matters.
- Due diligence requirements through the supply chain to identify, prevent, mitigate and account for abuses of human rights, including the rights of the child and fundamental freedoms, serious bodily injury or health risks and environmental damage, including with respect to climate.

The onshoring of the EU ESG package to the UK from the end of the Brexit transition period (31 December 2020) is to date, unclear. The UK Government has promised to 'match the ambition' of the EU Action Plan and it is expected that the UK Government will make an announcement on the subject in due course.

The UK's Ambitions

As a world leading financial sector, UK banks and other financial institutions play a huge role in financing global business. However, the fundamentals that underpin the UK's status as a global financial centre are under scrutiny. The All-Party Parliamentary Group on Sustainable Finance states that 15% of the world's emissions are financed in London and 17% of the dividends paid out on the London Stock Exchange come from high carbon businesses.

In 2019, the UK became the first major economy in the world to pass laws to end its contribution to global warming by 2050. The target will require the UK to bring all greenhouse gas emissions to net zero by 2050, compared with the previous target of at least 80% reduction from 1990 levels.

The UK has already reduced emissions by 42% while growing the economy by 72% and has put clean growth at the heart of its modern Industrial Strategy. This could see the number of "green collar jobs" grow to 2 million and the value of exports from the low carbon economy grow to £170 billion a year by 2030.

To achieve this ambitious target, requires the cooperation and collaborative efforts of both the public and private sector. Policy makers need to develop financial policies that not only help to develop markets and build a resilient economy, but also direct finance towards the zero carbon sectors of the future.

The All-Party Parliamentary Group on Sustainable Finance supports parliamentarians to understand more about sustainable finance and brings together policy makers, industry players, academics and practitioners to build political consensus for the changes required in the finance sector to help reach net zero.

Policy and regulation will be a key enablers of finance flowing into the green businesses of the future. The Green Finance Institute (GFI) in the City of London is working hard to ensure that a pipeline of green finance opportunities opens up in London and across the world. This pipeline could reconfirm London as a global finance hub for the new green economy.

Financial regulators are also looking at ways to advise and guide the sector on developing policies, products and services that contribute to the 2050 target.

The Bank of England and the Financial Conduct Authority joined forces in 2019 to convene the Climate Financial Risk Forum (CFRF) to build capacity and share best practice across financial regulators and industry, and advance the sector's responses to the financial risks from climate change.

It brings together senior representatives from across the financial sector, including banks, insurers, and asset managers. The forum also includes observers from trade bodies to represent a broader range of firms and ensure the outputs of the CFRF are communicated to their members. Since its inception in March 2019, the CFRF has set up four technical working groups on disclosure, scenario analysis, risk management and innovation.

On 29 June 2020 the CFRF published its guide to help the financial industry approach and address climate-related financial risks. The guide aims to help financial firms understand the risks and opportunities that arise from climate change, and support firms as they adapt their risk, strategy and decision-making processes to reflect climate-related financial risks.

Extent of the changes

Whilst on paper the changes may not look particularly significant, the effect should not be underestimated. Regulators and policy-makers alike have indicated that they expect ESG to be woven into the fabric and infrastructure of institutions. So, it is not merely a case of extra disclosure requirements (even though it may appear so at first glance), institutions will be required to demonstrate exactly how they have considered ESG matters in the conduct of their business as a whole.

What can you expect next?

A carrot and a stick.

Regulators and policy makers alike appear to be corralling FMPs into sustainable finance by the dual use of the 'carrot' and the 'stick' approach.

The 'carrot' approach encourages FMPs to engage in ESG through the use of incentives. We anticipate that, in the future, further financial incentives will be offered. For example, reduced taxes for ESG projects; lower capital regulatory requirements for holding ESG products; and the offer of further opportunities if you hold a certain percentage of ESG products.

The 'stick' approach requires firms to adhere to regulatory obligations regarding ESG matters or face sanctions. We anticipate there will be further disclosure and transparency requirements implemented together with thresholds as to how many ESG investments FMPs should hold in their portfolios. Failure to meet such criteria may result in financial sanctions or regulatory sanctions.

What should you be doing?

FMPs of all sizes should be re-evaluating their stance on ESG matters now, to avoid being caught out by regulatory changes in the near future. FMPs should be asking themselves:

- Is there a sufficient emphasis on ESG in our practise (both from an investment standpoint and a staff and culture standpoint)?
- How do we demonstrate our commitment to ESG matters – do we see it as a tick-box approach?
- Can we set any hard internal targets to commit to ESG matters?
- Are we aware of the regulatory landscape regarding ESG and are we in a position to adapt to the quickening pace of ESG obligations?
- Do we know the extent our current ESG obligations?
- Are we aware of the incentives and advantages ESG can offer to us (both regulatory and financial)?

Failing to get up to speed with ESG now could result in issues in the future including the risk of fines, litigation, investigations, investors withdrawing money from funds and banks refusing to do business with them if they are unable to prove they are satisfying their ESG requirements.

Voluntary industry initiatives should not be underestimated and FMPs can demonstrate their commitment to ESG matters by signing up to responsible investment initiatives now. For example, the following schemes have become increasingly important in the investment world and are considered by investors as a good way of demonstrating commitment to ESG matters (amongst many others):

- United Nations Principles for Responsible Investment
- Sustainability Linked Loan Principles
- Sustainable Development Goals
- Green Loan Principles
- CFRF guide to help the financial industry approach and address climate-related financial risks
- AccountAbility 1000 standards
- Davos Manifesto
- Business Charter for Sustainable Development
- UN Global Compact
- Equator Principles (EPs)

A just transition

The next few years are critical in the development and implementation of legislation that can guide and regulate ESG in finance and in turn, support the UK's ambition to bring all greenhouse gas emissions to net zero by 2050.

Over the next decade, the UK financial sector will be held accountable for its role in financing ESG compliant organisations and will be judged on its efforts to reduce finance in businesses and projects that are detrimental to the environment or society.

Banks and other lenders will need to show how they are aligning their balance sheets with the UK's net-zero greenhouse gas emissions target. They will need to demonstrate their commitment to financing ESG-centric companies and projects, and any non-compliant business on the loan books will have serious implications not only for their reputation.

Fieldfisher can provide guidance and support to banks and other financial institutions on the regulatory and legislative changes that will impose ESG requirements on their business.

Contacts

Dougall Molson

Partner, Financial Markets
and Products

+44 (0)20 7861 4032
dougall.molson@fieldfisher.com

Simon Lafferty

Senior Associate
Financial Services

+44 (0)20 7861 4932
simon.lafferty@fieldfisher.com

Guy Usher

Partner and Co-head
of Financial Services

+44 (0)20 7861 4209
guy.usher@fieldfisher.com

Philip Abbott

Partner and Co-head
of Financial Services

+44 (0)20 7861 4065
philip.abbott@fieldfisher.com