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CLEARY GOTTLIEB

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Climate and the Financial Sector

This weekly newsletter highlights climate-related regulatory, litigation and enforcement developments relevant to the financial sector.

General

21 November 2023 [EU] –Taxonomy Delegated Regulations published in Official Journal

The European Union has published Commission Delegated Regulation (EU) 2023/2485 (here) (the "**Amending Taxonomy Climate Delegated Act**") and Commission Delegated Regulation (EU) 2023/2486 (here) (the "**Taxonomy Environment Delegated Act**") in the Official Journal of the European Union.

The Amending Taxonomy Climate Delegated Act amends Delegated Regulation (EU) 2021/2139 (the "**Taxonomy Climate Delegated Act**"), establishing technical screening criteria for additional economic activities to determine the conditions under which such economic activities will qualify as contributing substantially to climate change mitigation and/or adaptation. The Amending Taxonomy Climate Delegated Act largely extends the coverage of economic activities within the transport sector and its value chain, including some manufacturing activities for components for low-carbon transport and electrical equipment and some transitional activities in waterborne transport and aviation. With the exception of an amendment to Appendix C of the Climate Delegated Act (which begins to apply from 1 January 2025), the Climate Delegated Act will come into force on 1 January 2024.

The Taxonomy Environment Delegated Act establishes the technical screening criteria to determine when certain economic activities qualify as contributing substantially to non-climate environmental objectives, i.e., the sustainable use and protection of water and marine resources, the transition to a circular economy, prevention and control of pollution, and protection and restoration of biodiversity and ecosystems. The Taxonomy Environment Delegated Act also amends Commission Delegated Regulation (EU) 2021/2178 to align disclosure requirements. The Environment Delegated Act applies from 1 January 2024.

Banking

17 November 2023 [EU] – **EBA publishes final templates to collect climate-related data from EU banks**

The European Banking Authority ("**EBA**") has published the final templates (here) for collecting climate-related data from EU banks in the context of the one-off Fit-for-55 climate risk scenario analysis exercise. This exercise is designed to assess the resilience of the financial sector in line with the Fit-for-55 package (a set of legislation that sets the EU on a path to achieving a 55% reduction in net greenhouse gas emissions by 2030), and to gain insights into the capacity of the financial system to support the transition to a lower carbon economy under conditions of stress. This exercise will be conducted in collaboration with the other European Supervisory Authorities, the European Central Bank, and the European Systemic Risk Board.

The templates will be used to collect data from 110 EU banks (to be disclosed by the EBA) and collect information on credit risk, market risk and real estate risk. They are accompanied by a template guidance (here) which provides participating banks with the definitions and the technical guidance for populating the templates.

The data collection will begin on 1 December 2023 and will be completed on 12 March 2024.

17 November 2023 [EU] – **EBA publishes monitoring report on IFRS 9 implementation, emphasising need to take ESG factors into account as part of ECL models**

The EBA has published its 2023 monitoring report on the implementation of IFRS 9 by EU institutions (here), focusing on Expected Credit Loss ("**ECL**") outputs in high default portfolios. The report is based on findings arising from the EBA's IFRS 9 benchmarking analyses of the data and information collected on 37 institutions from 14 EU countries during its third ad hoc data collection on IFRS 9.

The report contains an analysis of ESG risk, including climate risk. While generally considering the risks stemming from ESG (including climate) as being material, very few institutions have taken ESG factors into account in their ECL models (although many institutions have indicated that the inclusion of ESG aspects in ECL models is under discussion). Different methods were mentioned to include those risk factors, for instance, the update of existing rating assessment models or development of dedicated ESG ratings, the use of sectoral models or overlays, the inclusion of physical risk in collateral valuation or the adjustment to the macroeconomic scenarios. The report emphasises that institutions are expected to continue progressing towards the integration of climate and sustainability-related risks in ECL outputs.

The EBA will continue monitoring and promoting the consistent application of IFRS 9. The observations reported in the monitoring report will inform future exchanges with stakeholders on IFRS 9 implementation.

21 November 2023 [EU] – **The EBA publishes final standards for supervisors assessing new market risk internal models, including requirements to consider climate change risk and broader environmental issues**

The EBA has published its final draft Regulatory Technical Standards ("**RTS**") (here) on the assessment methodology under which competent authorities verify institutions' compliance with the requirements applicable to their internal models under the Fundamental Review of the Trading Book rules.

Risks stemming from climate change and broader environmental issues are changing the risk profile for the financial sector and will become even more prominent in the future. Therefore, the RTS explicitly requires competent authorities to verify that institutions consider climate and related risks in their stress testing programmes for internal models. While this requirement may increase the burden for institutions, the EBA believes that an explicit specification to use climate risks in the stress test scenarios is important, given the increased relevance of these risks going forward.

Given the novelty of this requirement, competent authorities are to assess this aspect from 1 January 2025 only.

22 November 2023 [EU] – **ECB publishes November 2023 Financial Stability Review**

The European Central Bank ("**ECB**") has published its November 2023 Financial Stability Review (here). Concluding overall that the euro area financial stability outlook remains fragile, the ECB's review includes a number of climate-change related observations.

First, the ECB noted that, in order to preserve resilience from a more structural perspective, euro area banks must carefully manage the effects of climate change. With regard to sovereign debt sustainability, medium- and longer-term challenges (including climate change) could add to financial stability risks. Climate change is also considered one factor contributing to greater inflation persistence and economic uncertainty, which, in turn, contributes to inflation swap forward rates having stayed elevated. Lastly, climate change is considered to be one of the major challenges that the ECB believes insurers will face over the longer term. Estimated global insured losses of USD 124 billion made 2022 one of the most expensive so far in terms of natural disasters. The rising frequency of major natural disasters due to climate change and the growing magnitude of associated losses have driven insurance prices up. This adds to profitability challenges faced by non-life insurers and might widen protection gaps (the proportion of economic losses not covered by insurance), which may adversely affect the macroeconomic situation and financial stability.

Insurance

23 November 2023 [International] **– IAIS published its second consultation on climate risk supervisory guidance**

The International Association of Insurance Supervisors ("**IAIS**") has published a second consultation on climate risk in the insurance sector (here). Part of a series that aims to promote a globally consistent supervisory approach to climate-related risks, this consultation focusses on proposed supporting material addressing issues relating to market conduct and scenario analysis, through the publication of two draft application papers.

The Draft Application Paper on climate risk market conduct issues in the insurance sector (the "**Conduct Paper**") (here) aims to support supervisors in identifying instances of potential unfair treatment of consumers in relation to sustainability-focused products or natural catastrophe ("NatCat") protection products, for example through "greenwashing" or misleading information on the sustainability of an insurer's operations. Importantly, in light of existing general requirements for insurers and intermediaries not to provide unfair and misleading information, the Conduct Paper also applies to insurers or intermediaries that make voluntary sustainability claims about their entity or their products, even if there are no specific sustainability-related requirements in that jurisdiction.

The Draft Application Paper on climate risk scenario analysis in the insurance sector (the "**Scenario Analysis Paper**") (here) focuses on the use of climate-related scenario analysis to understand the risks to which the insurance sector is exposed at a micro and macroprudential level. It considers why and how climate-related scenario analysis exercises should be used and the extent to which they can overcome some of the weaknesses of current methods for assessing risks. It also considers how climate-related scenario analysis should be considered in light of the standards set out in the Insurance Core Principles (ICPs) 16 (Enterprise Risk Management for Solvency Purposes) and 24 (Macroprudential Supervision).

The IAIS has requested feedback on the consultation by 23 February 2024 and plans to respond to the comments in 2024.

In the meantime, a public background session will be held via webinar on 12 December 2023 to present the papers and answer questions from stakeholders. Attendees must register here to attend.

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