CLEARY GOTTLIEB

5 September 2023

Climate and the Financial Sector

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

General

31 August 2023 [EU] – **ESMA published its second Trends, Risks and Vulnerabilities Report of 2023, including some findings on developments in the sustainable finance sector**

ESMA’s report notes that, while financial markets rebounded in H1 2023, overall risks remain high and markets are set to remain very sensitive. With regard to sustainable finance, ESMA observes that the market for ESG products and sustainable investment in Europe is still growing.

Despite a continuation of the reclassifications of funds from SFDR Article 9 to Article 8, the net flows into Article 9 funds have remained resilient. In fact, investors’ capital allocation might suggest that investors looking to invest in ESG funds are paying attention to the sustainability profile of funds rather than their specific SFDR disclosure regime.

The market for sustainability-related fixed-income products continued to grow (with the total value of ESG bonds outstanding reaching EUR 1.7 trillion in June 2023, up 28% in 1 year), albeit that issuance volumes remained lower across all ESG bond types (down 8% in H1 2023 compared to H1 2022). ESMA considers the fact that almost all

(99%) ESG bond issuances in 2023 were labelled to signal a high commitment to adhere to existing market standards.

For further information, please refer to the report here.

1 September 2023 [UK] – **Green Technical Advisory Group publishes reports advising on scope and reporting under UK green taxonomy**

The Green Technical Advisory Group ("**GTAG**"), an expert group made up of key financial market stakeholders and subject matter experts which provides independent, non-binding advice to the UK Government on the design and implementation of the UK Green Taxonomy, published two reports.

The first report (here) focuses on the scope of the UK's Green Taxonomy. Regarding the question whether the UK Green Taxonomy should be extended to cover transition and harmful activities, the GTAG does not recommend such extension at this stage but instead considers that this should be left for later review. The reason is that, at this point in time, the UK Government should prioritise delivering a robust, usable green taxonomy that clearly defines 'green' economic activities and is viewed as a credible. Regarding expansion to cover other sectors/industries in the UK, the taxonomy should be prioritised for certain sectors and activities. Regarding the scope of reporting, the GTAG advises that taxonomy reporting should apply to companies subject to mandatory Taskforce on Climate-related Financial Disclosures ("TCFD") reporting.

The second report (here) focuses on effective reporting, identifying challenges with the European taxonomy reporting and seeking to address these in respect of the UK's Green Taxonomy. In addition to overarching design and sequencing considerations, the report discusses specifically reporting by non-financial companies, credit institutions and investors, and makes recommendations relating to each of these. In respect of credit institutions, the GTAG recommends reassessing the approach to Green Asset Ratio ("**GAR**"), either by excluding non-relevant activities/investments from the GAR calculation or restricting GAR calculations to the bank's lending book only. Moreover, the GTAG recommends the setting up of a working group to design Technical Screening Criteria ("**TSC**") for financial services that capture and measure incentive schemes promoting green behaviour. With regard to investors, the GTAG recommends reporting at the fund level and disclosing taxonomy components for each fund (instead of using the Green Investment Ratio at entity level); fund-level reporting should be applied to all funds, irrespective of ESG labelling. With regard to insurers' investments, own-account investments, made to offset the liabilities accrued from their underwriting activities, should be reported at entity level, whereas unit-linked or with-profit businesses, where the policyholders assume the investment risks and rewards, should be reported at product level. Lastly, the GTAG recommends the establishment of additional TSCs for the insurance sector, e.g., in respect of insurance premium discounts, adaptation measures, and financing activities for mitigation or adaptation.

4 September 2023 [France] – **The *Banque de France* makes its climate indicator available to companies**

Following a meeting of the French *Comité de Financement de la transition écologique* (a committee under the supervision of the French Ministry of the Economy), the Banque de France announces that it will make its climate indicator available to companies. The climate indicator aims to measure companies' exposure to climate risks and is currently being tested by 500 companies. The climate indicator will gradually be made freely available to all companies (from large companies to SMEs). [link]

Banking

1 September 2023 [International] – **NGFS publishes reports on trends in climate-related litigation and micro-prudential supervision of climate-related litigation risks**

The Network of Central Banks and Supervisors for Greening the Financial System ("**NGFS**"), a group of central banks and supervisors sharing best practices in relation to environmental and climate risk management, published two complementary reports on climate-related litigation risks.

The first report considers recent trends and developments in climate-related litigation (*here*). It highlights that climate-related litigation is growing rapidly, not only in terms of the volume of cases being initiated, but also in terms of the legal arguments being used, and the diversity of addressees of such claims. Such litigation can have a significant impact on the financial sector and its increased relevance indicates the importance of central banks and supervisors increasing their monitoring and raising supervisory expectations. Moreover, several cases have already been brought directly against defendants in the financial sector, including credit institutions. The report concludes that environment-related litigation is likely to increase, not least because the focus of litigants is expanding from climate change to environmental issues more broadly.

The second report considers micro-prudential supervision of climate-related litigation risks (*here*). The report notes the importance for supervisors to identify risks drivers, transmission channels and exposures in order to properly assess ensuing financial risks to a financial institution, which can lead to direct (e.g., damages, fines, legal and administrative fees) and indirect (e.g., insurance pay-outs, credit losses or adverse business impacts) costs for financial institutions. Noting that the supervision of the risks associated with climate-related litigation is still at an early stage of development and formal supervision methodologies not yet fully developed, the report sets out potential options for the micro-prudential supervision of risks and suggests that supervisors adopt a risk-based approach to better prioritize their supervisory activity.

4 September 2023 [EU] – **ECB Board Member Elderson gives speech, emphasising climate and environment-related litigation risk and the importance of Paris-aligned transition plans in the banking sector**

Elderson's speech highlighted the rise of climate and environment-related litigation, which is increasingly targeting corporates, including in the financial sector. Such litigation is becoming a major source of risk that needs to be properly anticipated and addressed by banks as well as supervisors.

One way banks can address this issue is by taking into account relevant risks (e.g., by factoring climate considerations into the assessment of clients' credit risk, or considering reputational risks such as those related to potential greenwashing and financing of polluting industries) and quantify possible losses. Moreover, banks can mitigate the risk of greenwashing by ensuring adequate disclosures, by considering this risk in the governance framework, and by conducting regular compliance checks. Elderson referred in this context to various guidance published by the ECB, including the 2020 guide on climate-related and environmental risks (here), and, in November 2022, the ECB's thematic review on climate-related and environmental risks (here) and compendium of good practices by supervised banks (here).

A second point emphasised by Elderson is the importance of putting in place Paris-aligned transition plans. Leaving aside that "*it is only a matter of time before bank transition plans become mandatory under EU law*", such plans require banks to ensure they have accurate, granular data; that they conduct a robust materiality assessment; that they integrate transition planning into their internal discussions and strategic decision-making and that they establish proper internal governance to this effect – all of which should contribute to reducing litigation risk.

For further information, please refer to the speech here.

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