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

16 January 2024 [UK] – **FCA to support financial advisers with product sustainability claims through industry-led working group**

As part of its package of measures to improve trust and transparency in sustainable investment products, the FCA has established an industry-led working group for financial advisers to support the industry in advising consumers on products that make sustainability claims. This package of measures, announced in November 2023, was presented as supporting the UK's position as a centre for asset management and sustainable investment, and aimed to protect consumers by helping them to make more informed investment decisions. It includes the introduction of an anti-greenwashing rule, product labels, and naming and marketing requirements to prevent products being described as having a positive impact on sustainability when they do not. The FCA will sit as an active observer of the group and has asked it to be ready to report in the second half of 2024 on how it can support the advice sector in delivering good practice. [link]

17 January 2024 [Global] – **ISDA launches Clause Library for Sustainability-linked Derivatives**

The International Swaps and Derivatives Association (ISDA) has launched a Clause Library for Sustainability-Linked Derivatives (SLDs) to provide market participants with standardized drafting options for use by counterparties when negotiating SLD transactions, including provisions relating to the delivery of evidence of sustainability performance, mechanisms for adjusting cash flows based on the achievement of relevant ESG targets, and options available to counterparties following disruption and review events. [link]

18 January 2024 [France] – **AMF publishes its action plan and supervisory priorities for 2024**

The chairwoman of the AMF, Marie-Anne Barbat-Layani, outlined the 17 priority actions covering the "Impact 2027" strategic guidelines defined in 2023, and explained that the AMF intends to lead an ambitious transformation towards sustainable finance. This includes helping firms to prepare their first sustainability reports under the CSRD, but also examining how investors' sustainability preferences are taken into account in the client pathway, and, in particular, promoting a review of the SFDR with a view to simplifying the SFDR transparency regime, and proposing minimum criteria for certain sustainable funds. With regard to asset management companies, particular attention will be paid to voting and shareholder engagement policies, which the AMF considers to play an increasingly important role in asset managers' ESG strategies and communications and have the potential to represent a strong commercial focus of their ESG approach. The quality of MiFIR, EMIR, SFTR, and CSDR reporting data is another priority action at the level of intermediaries and market infrastructures, while client sustainability preferences will be closely monitored at the level of investment service providers. [link]

18 January 2024 [France] – **ACPR modifies guidance related to the Article 29 LEC report**

The ACPR has published updated guidance on the sustainability reporting documentation to be submitted annually by certain insurance undertakings subject to Article 29 of the Energy and Climate Law. The guidance now refers to three recently issued Delegated Regulations, i.e. 2022/1214 on economic activities in certain energy sectors and their specific disclosures, 2023/2485 and 2023/2486, both of which set out technical screening criteria for qualifying substantial impact on climate change, water and marine resources and other key objectives. New requirements for in-scope entities include providing the ACPR with the summary tab of Appendices C, D, E, and G within six months of the end of the financial year and additional quantitative indicators in Appendix D. In addition, for a transition period ending 31 December 2025, in-scope entities will be required to disclose the proportion of their covered assets exposed to Taxonomy non-eligible and Taxonomy-eligible economic activities. [link - link]

18 January 2024 [EU] – **EU Parliament adopts directive banning misleading claims and greenwashing**

The European Parliament formally adopted at first reading a Directive of the European Parliament and of the Council on amending Directives 2005/29/EC and 2011/83/EU as regards empowering consumers for the green transition through better protection against unfair practices and better information. This Directive outlaws the use of terms such as “environmentally friendly”, “natural”, “biodegradable”, “climate neutral”, or “eco” without evidence, while introducing a total ban on using carbon offsetting schemes to substantiate the claims. Under this new legislation, only sustainability labels backed by official certification schemes or established by public authorities will be permitted. It also bans unfounded durability claims, prompts for early consumable replacement, and false advertising of goods as repairable. This Directive is intended to work together with the green claims directive, currently being discussed at committee stage in Parliament. The upcoming green claims directive will provide more specific and detailed conditions for using environmental claims. [link]

22 January 2024 [EU] – **ESMA publishes an of overview of planned consultation in 2024**

The European Securities and Markets Authority (ESMA) has published a table providing an overview of the consultation documents it plans to publish in 2024. ESMA’s planned consultations cover a range of topics and EU legislation, including in relation to ESG specifically RTS under the EU Green Bond Regulation in Q1 2024, RTS on the European Single Electronic Format for reporting sustainability information under the European Sustainability Reporting Standards (ESRS). [link]

22 January 2024 [EU] – **EFRAG consults on exposure drafts on sustainability reporting standards for SMEs**

The European Financial Reporting Advisory Group (EFRAG) has launched a public consultation on its exposure drafts of European sustainability reporting standards (ESRS) for listed SMEs (LSME) [here] and for the voluntary reporting for non-listed SMEs (VSME) [here].

EFRAG is developing the LSME standards for SMEs that are public-interest entities, including (a) those whose transferable securities are admitted to trading on a regulated market in the EU, (b) small and non-complex institutions, and (c) captive insurers and reinsurers (together “LSMEs’). The ESRS for LSME are expected to come into force on 1 January 2026, with an additional two-year opt out. The standards aim to set reporting requirements that are proportionate and relevant to the scale and complexity of the activities, capacities and characteristics of LSMEs (to facilitate access to finance for LSMEs, by ensuring the availability of standardised sustainability information). The exposure draft is one standard, composed of (i) three general sections, (“1. General requirements”, “2. General disclosures”, and “3. Policies, actions and targets”), and (ii) three sections dedicated to metrics (“4. Environment”, “5. Social”, and “6. Business conduct”).

The proposed VSME standards would provide a simple reporting tool for non-listed SMEs to respond to requests from their business counterparts for sustainability information in an efficient manner. The VSME standards are expected to standardise the current multiple ESG data requests (which pose a significant burden to non-listed SMEs), by reducing the number of uncoordinated requests they receive and improving their access to lenders, investors and clients. The exposure draft is structured in (i) a Basic Module, and (ii) two additional optional modules (a ‘Narrative-Policies, Actions and Targets (PAT)’ Module, and a ‘Business Partners’ Module).

The consultation will be open until 21 May 2024.

23 January 2024 [International] – **NGFS published technical document on purpose and use of scenarios**

The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) has published a technical document titled "NGFS scenarios: Purpose, use cases and guidance on where institutional adaptations are required" (here).

The NGFS scenarios (here) are a set of hypothetical scenarios created by the NGFS in partnership with a group of expert scientists. They provide a common and up-to-date reference point for understanding how climate change (physical risk) and climate policy and technology trends (transition risk) could evolve in different futures. They have been adapted to help central banks and supervisors explore the possible impacts of climate change on the economy and the financial system.

The document proceeds in three key sections – "How does scenario analysis help with assessing climate risk?", "How do the NGFS scenarios fit in the global climate scenarios framework?" and "What are the main use cases of the NGFS scenarios and in which cases might tailoring be necessary?" – followed by a collection of frequently asked questions. It sets out the purposes and practical applications of the NGFS scenarios, acknowledging the need for scenario users to clarify what they intend to achieve and to consider how the scenarios they use allow them to meet their objectives and/or specific requirements. The technical document also highlights certain areas in which users may need to adapt the overall intensity of the scenarios (including, amongst other things, financial sector dynamics, physical impacts that are not captured at present, and societal impacts such as migration influenced by climate change).

The NGFS scenarios provide clear evidence that early action delivering an orderly transition to achieve global net-zero emissions by 2050 is the optimal pathway for minimising climate-related risks and losses.

24 January 2024 [International] – **Financial Stability Board publishes Work Programme, including focus on addressing financial risks from climate change**

The Financial Stability Board (FSB) has published its work programme for 2024 (here). The work programme summarises ongoing and planned FSB initiatives in 2024.

The work programme notes that there is a growing focus on potential risks that climate change could pose to financial stability. Climate-related risks may be amplified by the financial system, across borders and across sectors, emphasising the importance of system resilience to the risks posed by climate change, including the need to manage transition risk.

The FSB plans to continue coordinating international work through the FSB Roadmap to address financial risks from climate change. The FSB is also continuing its work on climate data and vulnerabilities analysis, is undertaking analysis on the relevance of transition plans for financial stability, and will prepare an annual progress report on companies' climate disclosures.

In particular, in 2024, the FSB plans to: (a) report on progress in achieving consistent climate-related financial disclosures (planned for November), (b) analyse the relevance of transition plans and planning by financial and non-financial firms for financial stability, and (c) take stock of regulatory and supervisory initiatives related to the identification and assessment of nature-related financial risks (planned for July).

29 January 2024 [EU] – **Platform on Sustainable Finance publishes report on market practices regarding the EU's Taxonomy and sustainable finance framework**

The Platform on Sustainable Finance (PSF) has published a report on market practices relating to EU Taxonomy and sustainable finance framework (here).

The report reflects contributions of seven stakeholder groups, including large corporates, credit institutions, investors, insurers, public institutions, auditors and consultants, and SMEs. It takes the form of a compendium of market practices, spanning three areas: (i) the use of the EU sustainable finance framework for business strategy, transition planning and target setting; (ii) finance and transactions; and (iii) reporting, monitoring and assurance. It explores how the EU sustainable finance framework can be used to support and inform the transition efforts of economic actors, beyond mere regulatory compliance.

The report also presents various recommendations, including (i) peer-to-peer recommendations to encourage and accelerate the use of the EU sustainable finance framework for strategic and decision-making purposes, and (ii) recommendations and priorities for the PSF's future work in its advisory role to the European Commission.

31 January 2024 [EU] – **ESMA publishes first 2024 risk monitoring report**

ESMA published its first risk monitoring report of 2024 (here), where it sets out the key risk drivers currently facing financial markets.

While overall noting that markets have remained "remarkably resilient" in H2 2023, ESMA notes that, following several years of uninterrupted growth, the uptake of ESG investing and growth of ESG markets have levelled off in recent quarters. This is apparent from (i) the slower growth in the ESG bond market, (ii) accelerating outflows from SFDR Article 8 funds, and (iii) for the first time, net outflows from Article 9 funds. The report also highlights (i) the improvement in ESG data availability, and (ii) the decline in the price of EU and also UK emission allowances (with a stronger decline being observed in respect of UK emission allowance prices).

ESMA also notes that, overall, risks remain at (very) high levels. Amongst a number of risk drivers (e.g., interest rates, geopolitical risks) ESMA notes also greenwashing and related malpractices, which risk undermining the credibility of green finance. ESMA warns that, with the first outflows from ESG funds in 2023, future incidences, unless prevented effectively, may undermine investor confidence.

Asset Management

12 January 2024 [EU] – **ESAs update Q&A on SFDR framework**

The European Supervisory Authorities (EBA, EIOPA, and ESMA - ESAs) have published an updated version of the Q&A on the Sustainable Finance Disclosure Regulation ((EU) 2019/2088) and the Commission Delegated Regulation (EU) 2022/1288). This consolidated version, dated 12 January 2024, contains no substantive changes from the previous version published on 17 May 2023, except for the deletion of part of Question 1 on financial product disclosures, which previously asked whether it was necessary for a product to track an EU Climate Transition Benchmark or EU Paris-aligned Benchmark (where applicable) on a passive basis for Article 9(3) of SFDR to apply to said product. As the answer focused solely on whether Article 9 products should invest exclusively or partially in "sustainable investments", the EU CTB and PAB related part of the question has been removed. [link]

Banking

18 January 2024 [EU] – **EBA consults on Guidelines on the management of ESG risks**

As part of its mandate under Directive 2013/36/EU (CRD), the European Banking Authority (EBA) has launched a public consultation on draft guidelines on the management of ESG risks. Comments can be submitted until 18 April 2024. The draft guidelines aim to cover institutions' ESG risk management processes as part of their broader risk management framework. In particular, the draft guidelines set out requirements for the governance and ESG risk management arrangements that institutions should have in place. As such, they cover: (i) minimum standards and reference methodologies for the identification, measurement, management and monitoring of ESG risks by institutions; (ii) qualitative and quantitative criteria for assessing the impact of ESG risks on the risk profile and solvency of institutions; and (iii) the content of risk management plans to be prepared by the management body, including specific timelines and intermediate quantifiable targets and milestones, in order to monitor and address the financial risks arising from ESG factors. [link]

23 January 2024 [EU] — **ECB publishes report on risks from misalignment of banks' financing with EU climate objectives**

The European Central Bank (ECB) has published a report on risks from misalignment of banks' financing with the EU climate objectives (here).

The report notes that transition risks (which drive credit, market, operational and liquidity risk) can have a significant effect on the credit portfolio of a financial institution, and that, if the transition towards a decarbonised economy becomes disorderly, there will be a growing need to quantify the transition risks in banks' credit portfolios.

The ECB observes that that the euro area banking sector shows substantial misalignment and may therefore be subject to increased transition risks (primarily in the form of elevated credit risk). Further, around 70% of banks are also subject to elevated reputational and litigation risk, as they have committed to the Paris Agreement, but their credit portfolio is not aligned with it. Moreover, some of the most misaligned credit portfolios have a relatively high exposure compared with their CET1 capital, suggesting a potential impact on solvency for the credit-issuing institutions. The misalignment largely stems from financing counterparties that are either too slow to phase out their high-carbon production capacities or too slow to build out their renewable energy production capacity.

In a recent blog post (here), Frank Elderson of the ECB explains that the misalignment with the EU climate transition pathway can lead to material financial, legal and reputational risks for banks, and that it is therefore crucial for banks to identify, measure and manage transition risks, which is why transition planning is essential.

24 January 2024 [EU] – **European Commission publishes report on macroprudential review for banks and systemic risks for NBFIs, highlighting significance of climate change and other environmental risks**

The European Commission has published a report (here) on its review of the EU macroprudential framework for credit institutions set out in the Capital Requirements Regulation (575/2013) (CRR) and the CRD IV Directive (2013/36/EU), as required under Article 513 of the CRR. The report notes certain shortcomings in the EU's macroprudential framework, including, amongst others, the ability of the macroprudential toolkit for banks to address certain conventional and new risks, including climate change and environmental degradation.

Transition and physical risks impact individual financial institutions and the broader financial sector (including non-bank financial intermediaries). These risks (including, e.g., extreme weather events or sever floods) can affect borrowers' solvency and the value of real estate loan collateral equally. Moreover, assets that generate significant greenhouse gas emissions could be subject to accelerated depreciation, as the economy moves towards climate neutrality in line with the EU climate law.

The report accordingly notes that anticipating, monitoring and mitigating financial stability risks linked to climate change and environmental degradation is increasingly becoming an essential task for national and EU authorities. A significant exposure of financial institutions to these assets should be covered with adequate buffers. Currently, climate-related financial risks are mainly considered in stress-tests, but they are not yet factored in more broadly in macroprudential requirements. The EU and international fora (ESRB, ECB, the FSB, the NGFS), are in discussions how to better tackle these risks with macroprudential tools. The agreement reached on the "Banking Package" clarified that the systemic risk buffers could be used to deal with risks related to climate change and climate transition.

29 January 2024 [EU] — **EBA seeks inputs from credit institutions on classification methodologies for exposures to ESG risks**

In compliance with its mandates under Article 501c of the Capital Requirements Regulation, the EBA published and industry survey on the classification of exposures to ESG risks (here). This follows on from the EBA's October 2023 report on the role of environmental and social risks in the prudential framework published (here).

The survey has six sections, covering the following points respectively: (i) general information about the participating credit institution; (ii) general information on he used methodology for the identification of ESG risks and possibly the qualification of exposures subject to them; (iii) exposures to NFCs; (iv) exposures to non-retail SMEs; (v) exposures to retail SMEs; (vi) exposures to households.

Each section is divided in two sub-sections:

1. Questions related to the identification of ESG risks, aiming to capture information on how credit institutions map their (banking book) credit exposures to ESG risks and how they collect corresponding data. This includes questions on the use of (A) ESG scores, (B) transition and physical risk indicators made available by sustainability disclosure reporting frameworks, (C) guidance and conclusions coming from supervisory stress-testing or scenario analysis of climate-related financial risks; and (D) additional elements such as counterparty level information and internal stress-testing.
2. Questions related to the qualification of ESG risks, aiming to capture information on credit institutions' approaches and methodologies to classify (banking book) credit exposures according to potential pools/levels/buckets of differing ESG risks. These potential ESG risk pools/levels/buckets should not necessarily reflect changes in prudential risk parameters such as e.g., PD, LGD.

The deadline for submitting a response is 29 March 2024.

30 January 2024 [EU] — **ECB expands its work on climate change**

The ECB has published its nature and climate related plans for 2024 and 2025 (here), showing an increased focus by the regulator on climate change.

The plans identify three focus areas that will guide the ECB's work over 2024 and 2025:

1. **navigating the transition to a green economy**, which will involve intensifying the ECB's work on transition funding, green investment needs, transition plans and how the green transition affects aspects of our economy such as labour, productivity and growth. The results will also inform the ECB's macro modelling framework. Furthermore, the ECB will explore potential changes to its monetary policy instruments and portfolios.
2. **addressing the increasing physical impact of climate change**, including a deeper analysis of the impact of extreme weather events on inflation and the financial system, and how this can be integrated into climate scenarios and macroeconomic projections. The ECB will also assess the potential impact of adaptation, or lack thereof, to climate change on the economy and financial sector, including related investment needs and the insurance protection gap.

3. **advancing work on nature loss and degradation**, including analysing the close link with climate change, and the associated economic and financial implications. The ECB will also further explore the role of ecosystems for the economy and the financial system.

The work planned for these focus areas will complement the ECB's current climate-related actions in its ongoing tasks, including monetary policy and banking supervision.

Insurance

22 January 2024 [France] – **ACPR publishes report on insurance undertakings' disclosures under Article 29 of the Energy-Climate Act**

The report on the application of Article 29 of the Energy and Climate Law aims not only to evaluate the practices of insurance and supplementary occupational pension organizations (*organismes de retraite professionnelle supplémentaire*), but also to improve their future publications by clarifying the ACPR's expectations. The ACPR notes that while most in-scope institutions have published the Article 29 Report, the content of these reports is very heterogeneous and none of them meet all regulatory requirements in terms of completeness, accuracy or precision of the information published. It sees an improvement in 2023, although the heterogeneity has also increased. The standard layout established by the ACPR in an instruction has not always been followed, making it difficult to compare reports. The ACPR also observes that a significant proportion of in-scope institutions have not published or submitted their reports to the ACPR within the regulatory deadlines. It recalls that institutions must publish their report on their website and send it to both the ADEME and the ACPR. With regard to the information to be provided by institutions subject to the SFDR, the ACPR's findings are similar, in particular that the main negative impacts on sustainability factors are completed, but the related explanations required by the regulations are not very detailed or even absent. [link]

24 January 2024 [EU] – **EIOPA chair delivers speech on climate-related protection gaps, emphasising importance of cooperation, communication and investment**

The chair of the European Insurance and Occupational Pensions Authority (EIOPA), Perta Hielkema, delivered a speech at the World Federation of Exchanges (here).

The speech notes the human as well as economic costs of climate change, and, specifically in light of climate-change related extreme weather events, highlights that only one quarter of EU climate-related catastrophe losses is currently insured. Moreover, the speech observes that, as the climate-related catastrophes grow in both frequency and intensity, this protection gap can, absent any action taken, be expected to widen.

The speech highlights that, in addressing these risks, several aspects are key: (i) cooperation (e.g., between EIOPA and other regulators and authorities, both within and outside the EU), (ii) communication (e.g., in terms of raising awareness about climate change risks and sharing knowledge to incentivise adaptation and mitigation efforts), and (iii) investment (to facilitate flows of private capital towards the green transition).

5 February 2024 [EU] – **EIOPA publishes Insurance Risk Dashboard, finding that ESG related risks remain at medium level**

EIOPA has published its February 2024 Insurance Risk Dashboard (here).

While only market risk is currently at a high level (all other risk categories are at medium level) and the main concern for the sector, the Dashboard notes that ESG related risks remain stable at medium level.

Specifically, the Dashboard notes that (i) the median exposure towards climate relevant assets hovers around 3.3% of total assets, (ii) median investments in green bonds over total corporate bonds is at around 5%, (iii) the share of insurers' investments in green bonds over total green bonds outstanding is stable compared to the level of the previous quarter at 7%, (iv) the median exposure to flood risk slightly increased, while the median exposure to windstorm risk slightly decreased, (v) the cumulative catastrophe loss ratio increased, due to increased cat losses for all reinsurers in Q2 2023, and (vi) the median ESG ratings of the insurers in the sample remained around A-, but the gap between the lower and higher tails of the distribution widened.

Amélie Champsaur
Partner, Paris
achampsaur@cgsh.com

Andreas Wildner
Associate, London
awildner@cgsh.com

Pierre Mathé
Associate, Paris
pmathe@cgsh.com

Camille Kernevès
Associate, Paris
ckerneves@cgsh.com