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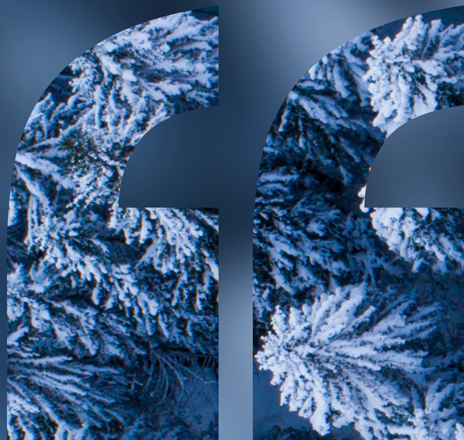

# ESG: STAYING AHEAD OF THE REGULATORY CURVE IN EUROPE

— THOUGHT LEADERSHIP

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# ESG: STAYING AHEAD OF THE REGULATORY CURVE IN EUROPE

Central banks, financial regulators and governments around the world are focusing on the risks that climate change poses to the global economy. There are a number of factors in managing those risks, including the need for a robust categorisation system for "green" or "sustainable" investments, as well as reliable data on how companies and assets are performing against that categorisation. In this extract from a recent webinar, Clifford Chance experts discuss the latest developments in green and sustainable financial products and the impact of upcoming European legislation.

Investment into ESG has accelerated and now stands at over USD30 trillion in AUM, having grown more than a third since 2016. "Of course, as responsible investment practices have evolved, with it has come increased market awareness that ESG issues can have material financial and reputational consequences," says Jeroen Ouwehand, Clifford Chance's Global Senior Partner and chair of the Firm's global ESG board. "Regulated entities such as asset managers, banks, financial investors and insurance companies need to stay ahead of the wave of regulation that is heading their way."

## New regulation

The EU's Sustainable Finance Taxonomy Regulation sets out a framework for labeling what qualifies as a sustainable financial product, but it is a complex process as London-based Partner Caroline Dawson, who specialises in Financial Regulation, explains: "As people have been developing that Taxonomy, they have had to deal with what is quite a vexed question of which activities are sustainable in and of themselves. But then there are other activities which may contribute to a transition to a sustainable economy; for example, nuclear power, natural gas and industries that normally you would consider to be polluters, but which are actually making significant contributions to the transition."

At this stage, the Taxonomy is only intended to cover environmental sustainability, so the regulation provides for the Commission to publish a report by the end of December 2021 looking at extending the regulation beyond environmentally sustainable activities to look at, for example, social objectives.

"The EU is a first mover and it is going to be interesting to see if the EU Taxonomy becomes the global standard, or if we see some competing versions out there. The UK Chancellor has proposed that the UK develop its own version of the Taxonomy as part of its green finance agenda," says Dawson.

## The need for reliable data

For these categorisations to work, there needs to be reliable data to show how companies and assets are performing. There are a number of initiatives at global and EU level setting out transparency and disclosure requirements, including the sustainable finance disclosures regulation, which requires disclosures regarding climate change, mitigation and adaptation from 1 January 2022 and then moving on to disclosure for other environmental objectives from 1 January 2023. The detail of what needs to go into those disclosures is still being developed. "It's almost impossible to develop completely new requirements and have them perfect first time around particularly when they relate to an area that is still developing,"

says Dawson. "I think we would expect there to be a period during which we reach some sort of plateau for reporting requirements, and then we would expect to see the next generation of reporting requirements emerging after that."

## Risk management

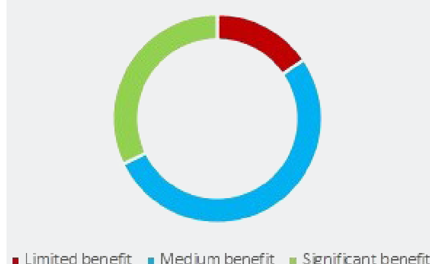
Financial regulators are increasingly focusing on risk management in the context of climate change. A potential capital penalty for financial institutions that have significant exposures to brown industries has been suggested, which raises some important policy questions, says Dawson. "The primary aim of the capital regime is supposed to be to require firms to hold capital to protect themselves against risk, so if you are aiming to offer capital discounts for particular products or imposing additional capital requirements on particular products, either you are making some type of assumption about the riskiness of those products or you are acknowledging that the capital regime isn't just about risk. I don't think the information is there at the moment, either to confirm that that's true as a general matter or to identify particular products where it is true."

She adds that there are difficulties with imposing a blanket brown penal factor. "There isn't a brown Taxonomy. If you're going to impose a penal capital factor for brown exposures or brown assets you need to have some definition of what constitutes brown. That is likely to be quite a difficult process and then you run the risk that it's not clear which Taxonomy – green or brown – an asset falls into. You run the risk of some industries losing access to finance in order to be able to transition to a more sustainable way of doing business."

Both the Bank of England and the ECB have announced climate-related stress testing and the IMF included climate stress tests in its recent review of Norway. "Regulators are strongly advising firms to start looking at the ESG risks to which they are exposed, thinking about the capital requirements that are appropriate to manage those risks but not necessarily at this stage, trying to prescribe particular treatments for particular assets. That is really very much left up to firms at present, " says Dawson.

She adds that it is important that new regulation around sustainable finance doesn't stifle new product development. "Regulations need to be appropriate and flexible enough to allow people to continue to develop new products without being hampered by limitations on the scope of what they can do within the regulatory regime."

**We asked our clients the following question: How beneficial to your organisation do you consider the EU's recent package of legislation aimed at implementing the EU Green Deal?**




## Sustainability risks

As the regulatory ESG landscape has evolved, there has also been a stronger focus on sustainability risks by financial market participants such as fund managers. One of the objectives set out in the European Commission's Action Plan, 'Financing Sustainable Growth' aims to reorient capital flows towards sustainable investments to achieve sustainable growth. "Fund managers need to take into account their duties towards investors," says Frankfurt-based Banking and Finance Partner, Gregor Evenkamp. "Managers should not only assess all relevant financial risks on an ongoing basis, but also all relevant sustainability risks that could have a material negative impact on the value of an investment."

Currently, however, neither the AIFM Directive nor the related Delegated Regulation explicitly refer to sustainability risks. In June 2020, the European Commission published a draft Delegated Regulation regarding the sustainability risks and sustainability factors to be taken

into account by AIFMs – and asked for feedback by 6 July 2020. That draft aimed to clarify that the processes, systems and internal controls of fund managers need to reflect sustainability risks, and that technical capacity and knowledge is also necessary to analyse those risks. Similar draft regulations have been published for, and consulted upon, by managers of UCITS funds, insurance undertakings and MiFID firms, as well as credit institutions.

"It goes without saying that sustainability risks form an essential part of any investment process – even if not yet explicitly provided for in European law," says Evenkamp.

The German regulator BaFin, an early adopter of regulation on sustainability risks, issued guidance in December 2019. It is addressed to entities supervised by BaFin, such as asset management companies and insurance undertakings, but made clear that the Guidance Notice serves as a compendium of non-binding procedures only (i.e., good practice principles). Evenkamp says that it needs to be seen as a useful addition to the already existing minimum legal requirements for risk management. Being mindful of upcoming European legislation, BaFin made clear that the Guidance Notice neither reduces nor extends any binding applicable legal requirements.

"The Guidance Notice defines the term "sustainability" on the basis of ESG criteria, and illustrates physical and transition risks. But as you can imagine, the central focus of the Guidance Notice is risk management," says Evenkamp.

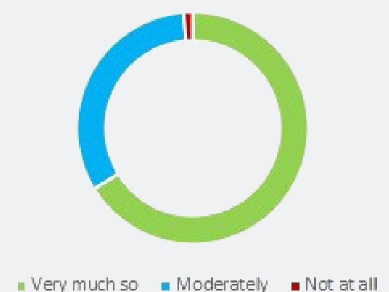
The starting point of BaFin is that traditional credit ratings take account only of the factors required to assess the creditworthiness of an entity or the credit risk of a financial instrument. These may, of course, include ESG factors. However, if ESG factors have no influence on the creditworthiness or the credit risk, then they should not be included as part of the credit rating. Instead, specialised ESG ratings can be used to determine the sustainability of financial investments. In this context, BaFin now reminds its supervised entities that pure ESG ratings should be clearly distinguished from established credit ratings, in order to avoid any confusion in the market. BaFin also identifies the current lack of unified concepts or general standards as the main risk attached to using ESG ratings. "Finally, BaFin encourages users of ESG ratings to not simply accept these when assessing the sustainability of a financial investment, but to proactively carry out appropriate plausibility checks," he says.

Early ESG compliance can make the difference and be seen as advantageous in a number of ways:

- attractive ESG-compliant products (for investors);
- enhanced corporate reputation;
- competitive advantages (by offering ESG-specific selling points);
- improved operational efficiency; or
- simply better risk management.

Evenkamp says that there is already a trend towards applying ESG regulations on a voluntary basis. Issuers of structured debt instruments, for example, seem to be neither in scope of the Disclosure Regulation nor of the Taxonomy Regulation. However, some issuers wish to also offer increased transparency around their financial instruments to investors and across the distribution chain. "In Germany, industry associations, for example, are establishing ESG transparency on a voluntary basis," he says.

**We asked clients the following question: To what extent do you see early ESG compliance as an advantage for your company?**



## Innovation in the green bonds market

The green bond market is mature. Issuances have reached a volume globally of USD315.15 billion (as at 20 September 2020, data provided by ICMA). However, there is still a lot of innovation in new product development. The green bond market began with issuances made by public institutions, local authorities, sovereigns and supranationals, and then by companies in specific sectors, mostly rail, infrastructure, energy and real estate. Now, all sectors and industries have identified specific green projects.

"The green bond market is different shades of green," says Paris-based Counsel, Auriane Bijon, who specialises in green financings. "It has expanded to other components of ESG, such as sustainable bonds, social bonds or COVID-19 linked bonds. What these products have in common is that the green or social or sustainable label will depend on the use of the proceeds received by the issuer. So the themed bond market is now much wider than just the "green" bond market."

In parallel, the market has seen the development of green loans. The green loan market has not taken the approach of focusing solely on the use of proceeds. Companies and public institutions often have back-up revolving facilities, the proceeds of which would be used to finance general corporate purposes and not specific green projects. To "green" these facilities, market players have used green KPIs – often based on their own ESG public disclosures – to build structures with financial incentives (such as a green margin or brown margin) to comply with these green KPIs.

Green loans has led to the creation of a new product on the debt capital markets – sustainability-linked bonds (SLBs). The first issuances of these bonds were made by energy group, Enel, in September 2019, followed by Chanel and Novartis in September 2020. "Now, issuers are coming to us to transpose the techniques used in their own green loans – often based on their existing green disclosure – into sustainability-linked bonds," says Bijon.

So what are they? Sustainability-linked bonds have been defined by ICMA, in its sustainability-linked bonds principles published in June 2020, as any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives. "The key takeaway is that issuers must identify KPIs which should be material to the issuer's core sustainability and business strategy. There is no need to allocate the proceeds to any specific projects," she says. For example, in Chanel's sustainability-linked bonds issuance, the KPIs of the issuer are to shift Chanel's operation to 100% renewable electricity, decrease its own emissions and decrease the absolute greenhouse gas emissions of its supply chain. In the case of Novartis, one of their KPIs is based on the objective to reach low and middle-income countries with strategic, innovative therapies.

## Greenwashing?

Some sectors will have more difficulties in being green than others, but as Bijon says: "Wouldn't even a minor impact in their carbon emissions have a significant impact? Shouldn't the whole economy take part in the global efforts and permit transitioning activities? Sustainability-linked bonds may be part of the solution as they complete the current toolbox by making it possible for issuers to transition to a lower carbon-intensive business and to commit to implement their green strategy. With this toolbox, issuers can chose the product that they feel is the most suitable for them and, in turn, investors will be able to choose the form of impact (whether green projects or KPIs) in which they believe most."

She adds that with the increasing popularity of green bonds and the fact that ESG is no longer considered as a "nice to have" but as a "must have", "all issuers – whatever their industry – are turning to us to see how they can enter the market. They are seeking advice as to how to structure and document typical green bonds or sustainability-linked bonds."

The French supervisory authority, the AMF, says that too many market initiatives and ideas are "cannibalising" the themed

bonds market, which already includes quite a number of different themes such as green bonds, Covid-19 linked bonds, social bonds, sustainable bonds, climate bonds and blue bonds. More generally, the AMF is taking the view that the market should fully align with the European initiatives aiming at a better harmonisation of practices and improvement of disclosure and transparency.

## Challenges for the green bond market

Issuers of green bonds will need to adapt to increasing harmonisation and regulation. "They initially had to comply with what the market expected. Now they are strongly incentivised, including by local supervisory authorities, to comply with various European initiatives," says Bijon.

In March 2020, a proposal for an EU Green Bond Standard was published. It is a voluntary standard which borrows heavily from the ICMA green bonds principles and is based on the standard use of proceeds approach. But one may only claim to be compliant with this standard if the proceeds of the issuance are in line with the EU Taxonomy Regulation. Also, external verification by a registered verifier, potentially accredited by the ESMA, will be mandatory.

And in September 2020, the ECB published a decision that bonds with coupons linked to sustainability performance targets will become eligible as central bank collateral, and therefore may be purchased under the asset purchase programmes of the ECB. This takes effect in January 2021. Conditional on this eligibility, however, is that the coupons are linked to a performance target referring to environment objectives set out in the EU Taxonomy Regulation and/or the United Nations Sustainable Development Goals.

"At this stage, neither the EU Green Bond Standard, the Taxonomy Regulation nor the ECB decision are fully in force, but we are seeing issuers trying to anticipate as much as possible their entry into force in their green frameworks," says Bijon. "The challenge will be for issuers to align their disclosure on the Taxonomy Regulation and for banks and investors to classify their existing investments in line with this regulation, which will probably not be a simple task, as it might depend on the product issued or on the activities of the issuer."

**We asked our clients the following question: Which regulatory measures do you think will have the most impact on the way your organisation manages Sustainability Risks?**

## What about insurers?

Sustainability, especially climate change, affects insurers uniquely, compared with other investors. It affects them on both sides of their balance sheet: on the liability side – because of the impact on the risks they underwrite; as well as on the asset side – on the assets they own as the largest institutional investors in Europe.

"Insurance is all about risk and managing risk," says London-based Partner Cheng Li Yow, who works in the Financial Institutions Corporate Group. In addition to the underwriting risk itself, insurers have regulatory obligations to consider, monitor and manage their prudential risks: e.g., investment, liquidity, operational, reputational and strategic risk. "The question though, is: what is Sustainability risk? Is it a totally new type of risk that should be considered separately and so needs to be monitored and assessed separately, or is it part of the existing categories of risks? This would have a big impact on the way that insurers manage their business and how they need information on their investments fed back to them," she says.

Regulators, so far, consider climate risk as having an impact on existing

categories of risks rather than being a totally separate category. But there is then a tension with the move towards standardised ESG ratings. Regulators have also made it clear that they expect insurers to be cognisant of the unique nature of sustainability risk: for example, Insurers must prepare Own Risk Self-Assessment (ORSA) reports. These ORSAs typically only require insurers to look three to four years ahead, but the effect of climate risk won't be realised until decades in the future. Regulators are now looking at how insurers must integrate climate risk into these assessments, with the Dutch Central Bank, for example, having formulated principles for this.

There is also a drive by regulators to have insurers stress test their resilience to climate change and to ensure insurers are properly identifying these risks. The Prudential Regulation Authority (PRA) in the UK runs a biennial industry-wide stress test, which requires all insurers in the UK to stress test their businesses against climate change and report back to the PRA. The results of these industry-wide tests are then used by the PRA to assess how resilient the industry would be to climate change and how well they are preparing. It also allows individual insurers to gauge how they are performing compared with their peers. The French, Australian and Singaporean insurance regulators are also carrying out similar industry-wide stress tests.

## Governance

Regulators want insurers to have the right corporate governance in place to make sure that the ESG and sustainability risks are identified, managed and dealt with throughout the organisation. In the UK, insurers must identify a specific Senior Manager function-holder to be responsible for climate risk. The Europe-wide insurance regulator (EIOPA) has also said that recruitment of dedicated ESG experts may be needed. "Regulators are, though, keen to stress, and rightly so, that it is not enough for this one person, or ESG function, to be responsible for climate risk," says Yow. "You can't just recruit an ESG expert and assume that the insurer has done its job on ESG. They expect climate risk to be integrated into all aspects of the insurer's business, because climate risk is not a separate thing on its own, but it permeates the entire business. And insurers are hearing this and embracing it. We see our insurance clients adopting ESG policies across their businesses and, more tellingly, now dedicating valuable resource into making this happen."

## ESG requirements for insurers as asset owners or investors

Insurers as asset owners (and especially life insurers, who often hold long-term assets to match their long-term liabilities) are also affected by the same issues as other financial investors. The Taxonomy and the Sustainable Finance Disclosure Regulation, for example, will apply equally to insurers. These will also impact insurers as providers of investment products. Insurers who write investment products, such as unit-linked insurance, will want the fund managers they use to manage these investments to comply with these requirements.

Also, in Europe under Solvency II, insurers are expected to invest in assets prudently. The PRA had taken the view that being prudent means taking sustainability risks into account in that assessment. The insurance regulator EIOPA has issued its opinion, saying it will amend the prudent person principle to make explicit that sustainability risks will need to be taken into account by insurers as part of its prudent person principle obligation.

"So far, regulators see climate risk as part of existing prudential risks. There is, however, discussion of whether firms could be incentivised to address climate change risk by incorporating it into firms' capital requirements," says Cheng Li Yow. The International Association of Insurance Supervisors (which is the association of the global insurance supervisors, including European and UK regulators) said it will look at this closely, because capital requirements are clearly a key factor in sustainability decisions.

The PRA in the UK has acknowledged that the question of whether climate risk

should be incorporated into firm's capital requirements is not easy to answer. "It isn't clear how this could be done, or indeed when. Would insurers be required to hold capital expressly against climate risks i.e., would there be a stick, or would there be a carrot instead. That is, will they be incentivised to invest in green investments by giving them positive capital treatment to invest in green?" she says.

**We asked our clients the following question: To what extent do you feel confident that your organisation will be able to stay ahead of the regulatory curve in Europe?**

## What's next?

- The EU is positioning itself as a first mover in this area. "Hopefully, for EU firms this means that other countries will aim to align more or less with the EU, reducing the compliance burden of implementing the various regulatory requirements," says Caroline Dawson. There are initial indications that firms with stronger ESG credentials have so far weathered the Covid-19 disruption better than comparable firms with less obvious ESG credentials. "Clearly this is something that will need to be studied more rigorously as transparency regimes and the market develop, but initial indications are that firms that perform well on ESG are well-positioned for the future," she says.
- With the rise of ESG credentials, the "S" (social) in ESG will be increasingly important. "Providing equality of opportunity and creating an inclusive work environment where everyone has the opportunity to succeed is about to become a societal expectation," says Gregor Evenkamp. According to current BCG research, 67% of millennials expect the companies they work for to be purpose-driven and their jobs to have societal impact. "Those firms that put ESG at the core of their business strategy will make the real difference and will be the ones able to attract and retain the very best people and talent to grow their business in the future," he says.
- The election of Joe Biden as US president could lead to a new global dynamic for climate issues. "If Biden's plans are fulfilled it could bring the goals of the Paris agreement "within striking distance", as his policy is to reach net zero carbon emissions by 2050," says Auriane Bijon.
- "Insurers have an extremely important role to play as asset owners, but I think they also have an opportunity to make a difference as providers of protection against climate risks," says Cheng Li Yow. She adds that with the need for more insurance protection, insurers may need to look for alternative sources of capital to support this business, and we've seen, for example, a growth of the insurance-linked securities market to let insurers get capital in from the capital markets. "Also, climate risks don't present themselves like most traditional underwriting risks, and there's the opportunity to use more innovative measures of risk. For example, we're seeing a lot more interest in using parametric and index-linked risk transfer solutions in the market."

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