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Focus on climate change

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The prolific announcements and media coverage surrounding COP26 provides plenty of commentary around climate change.

The calls for policy makers and businesses to integrate climate change in their decision-making are not new. Indeed, this has been a running theme in COP since the very beginning.

However, the significant progress achieved since the 2015 Paris COP is down to two main drivers:

First, the overwhelming scientific consensus that climate change is a significant threat to people, planet and our economies is no longer questioned, leading to a much stronger, and more urgent, case for change, further reinforced by the large number of climate-related natural disasters.

Second, the growing understanding by the wider financial services community that climate action is a driver of value, both in terms of risk mitigation and wealth creation. When the world's largest asset managers insist on receiving climate risk reports from some of the assets they invest in, the world's major central banks are pushing the case for climate stress-testing to maintain financial stability and the growth in debt capital markets is fuelled by a huge increase in green products, you know that finance is starting to play a part. Many financial institutions are now using their considerable influence over businesses and policy makers to enable the transition to a low-carbon future.

In this issue we consider the approach of financial regulators to climate change in response to governmental commitments and the gaps that need to be filled to maximise capital allocation for climate transition. Our next issue will cover the challenges and risks for financial institutions.

Where does COP26 take us?

As we summarised, COP26 yielded many notable achievements, but views on the outcome of the conference are mixed: there was disappointment with the watering down of the commitment on coal; muted optimism for commitments on methane emissions, deforestation, and public funds for developing nations; and hope for stronger commitments when parties meet again in 2022. At the end of the conference, the European Commission, amongst

others, announced its support for the COP26 agreement reached (the Glasgow Climate Pact), whilst emphasising the need for implementation and further commitments next year.

The role of finance was prominent at COP26. Highlights that we covered from the finance day of the conference included the G20 renewal of public finance commitments for developing nations, an impressive commitment announced by the Glasgow Financial Alliance for Net Zero (GFANZ) of $130 trillion assets under management from private finance to be managed in accordance with net zero goals, and various initiatives around changes to the capital markets to facilitate green finance.

In part to encourage further progress, international bodies and nations made many commitments in advance of COP26. The UK Government published its Roadmap to Sustainable Investing before the conference, which sets out its long-term ambition to green the financial system, align it with the UK's net zero commitment and make the UK "the best place in the world for green and sustainable investment". The paper sets out Phase 1 of the government's plan to support the transition to net zero. We summarise the key points of the roadmap, which contains key elements of the UK's strategy, including a new economy-wide disclosure regime and the long-awaited UK Green Taxonomy.

In the US, the Financial Stability Oversight Council published a report, for the first time identifying climate change as a risk to financial stability. The report acknowledged progress by US regulators so far, but emphasised the additional work needed to address the emerging climate-related financial risks, including risks associated with data, disclosure and scenario testing. The acting Comptroller of the Currency also recently announced that the Office of the Comptroller of the Currency (OCC) plans to develop "high-level climate risk management supervisory

expectations for large banks" and hopes to issue a framework of guidance for public comment by the end of the year.

Likewise, Hong Kong's Green and Sustainable Finance Cross-Agency Steering Group, with representatives from financial regulators as well as various government departments, announced during COP26 its support for the COP26 goals, and has reaffirmed its commitment to strengthening Hong Kong's financial ecosystem for a greener and more sustainable future.

Amongst the international bodies, the IFRS Foundation announced that it will create an International Sustainability Standards Board (ISSB) to develop sustainability disclosure requirements and create a single set of standards to meet investors' information needs. A consistent approach to disclosure is critical to enable financial markets to play a role in ensuring assets are properly priced and avoid cliff-edge corrections.

The Glasgow Climate Pact may just have kept hopes for 1.5 degrees alive, but the focus will now move very quickly to COP27 in Egypt and COP28 in the UAE. Stronger commitments to net zero will be sought, and there will need to be a focus on monitoring the progress of commitments already made.

Financial regulation continues to develop at pace

Over the last few years, regulators have focused primarily on areas such as ESG disclosures, transparent labelling of financial products, risk management and governance of climate change risk. Prudential regulators have recently turned their attention to the implications of climate change on capital. The European Central Bank (ECB) published a theoretical justification for adjusting capital requirements for climate-related risks. The UK's Prudential Regulation Authority (PRA) concluded in a recent paper that capital requirements should not be used as a climate change policy tool: they should be used to address the consequences of climate change, but not its causes. Elsewhere in Europe, the European Central Bank (ECB) reported on progress made by eurozone banks in meeting its expectations on climate and environmental risks. The ECB found that eurozone banks need to make more progress, particularly in internal reporting, market and liquidity risk management, and stress testing. The ECB will require banks to conduct climate risk stress testing in H1 2022 whilst continuing to assess banks for other aspects of climate adaptation.

Work on product labelling and disclosure continues. In early November, the UK's Financial Conduct Authority (FCA) published a discussion paper on COP26's finance day as part of the FCA's ESG strategy. The discussion paper is intended to help shape the FCA's future work on sustainable product labelling and entity level and product level ESG disclosures, which would allow investors to make effective investment decisions around sustainability. In the US, the Securities and Exchange Commission (SEC) has sought public comment on ESG disclosures and announced that it intends to issue mandatory climate disclosure rules by the end of the year. In addition, the US Federal Reserve Board has created committees tasked with

assessing how to incorporate climate risks into supervision of financial institutions.

In Hong Kong, the Monetary Authority (HKMA) has been consulting the banking industry on a draft Supervisory Policy Manual module on climate risk management, which shares some key elements with the Hong Kong SFC's framework.

The Hong Kong SFC has issued revised guidance to management companies of SFC-authorised unit trusts and mutual funds on enhanced disclosures for ESG-focused funds, which comes into effect on 1 January 2022. The revised guidance will complement the SFC's other proposals aimed at reducing the risk of greenwashing.

Major gaps in commitments persist for the financial services sector

Although progress has been made in financial sector policy making, there remain areas where regulatory policy and international coordination will need to increase:

Standardisation – Many large, international institutions seek consistency between regulatory frameworks in different jurisdictions where they operate to reduce compliance costs and enable global businesses to operate efficiently and effectively. In practice, even where international standards or rules are widely adopted, such as the TCFD framework for disclosures, the challenge of international compliance will persist when individual jurisdictions implement their own version of the framework that is similar, but different, to that implemented elsewhere. Against complete harmonisation, there is an argument that the rules implemented, and the timing of implementation should be aligned to other regulatory and market developments in any particular jurisdiction. The TCFD framework and the ISSB are important steps in the direction of standardised disclosure and accounting

criteria but are not adequate on their own to satisfy those who believe international harmonisation is necessary. Widespread international acceptance, adoption and consistent implementation of these common standards will be critical to their effectiveness.

Protection to prevent free riders – Without full international adoption of common standards and requirements, there is a potential free rider problem, which could affect the real economy and financial sector alike. Strict rules on carbon emitting industry and higher compliance costs for financial institutions operating in some jurisdictions may give a competitive advantage to financial institutions and industry in jurisdictions without those rules and costs. Europe is considering a protective border measure relating to carbon emissions aimed at preventing arbitrage. The questions are whether the number of jurisdictions adopting comparable measures will be sufficient to avoid the arbitrage of capital, whether there will be a substantial impact on the major international financial centres and whether protectionist measures will be needed to mitigate the free rider problem.

Data – ESG credit ratings are emerging to address the paucity of data for entities involved in green projects, and financial products issued with green credentials. Because each credit rating body uses different criteria, however, they are not yet sufficiently reliable to provide investors with an accurate guide for investment decision-making. The creation of common international standards by the ISSB could provide an important underpinning for ESG ratings, but this is an area where regulators may need to step in to require standardised data and/or criteria for ESG ratings.

Transition of long-term portfolios – Long-term asset owners need to recalibrate their investment objectives and investment decision-making to support investment for the climate transition. As highlighted in the UNEP's Legal Framework for Impact report,

change to legal and regulatory frameworks at a national level in many jurisdictions is needed to enable firms to pursue ESG investing within these large portfolios more easily and with lower risk of investor claims.

State aid rules and competition law – To meet the massive investment requirements for the transition, nations may need to reconsider state aid or industry subsidy rules to allow greater flexibility in public/private finance and timely investment decisions, for example in the EU and UK. There is also scope for industry collaboration to progress sustainability objectives but reassurance is needed from competition authorities that they will not pursue competition enforcement actions in this context. The European Commission is considering competition law implications, as are other authorities around the world.

Climate change is a significant threat to people, planet and our economies. At COP26, governments, regulators and the financial community recognised the crucial role that financial services play in the transition. Financial regulation continues to develop at pace but major gaps persist that require further development and international coordination.

Climate action as a driver of value

In our next issue we will consider the challenges, risks and opportunities for financial institutions arising from the climate change agenda. For insights on other developments in the financial services arena, you can review our earlier editions here.

If you would like to provide feedback on this or other editions, please contact Laura Feldman.

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