ECO:FACT QUARTERLY

The briefing for E&S risk experts

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ECO:FACT QUARTERLY
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Editorial

Required reading: the EBA report

We're delighted to welcome Bruno Bischoff as our new Head of ESG Risk Advisory. Many of you may have met Bruno, who joined us on October 1, during his time as Global Head of Sustainability Risk at Credit Suisse. Bruno was with the bank for 20 years, serving in various public policy and sustainability roles. He joins me in this *ECOFACT Quarterly* editorial.

During one of our first coffee breaks, we discussed the EBA ***Report on Management and Supervision of ESG Risks for Credit Institutions and Investment Firms*** published in June. Financial market regulators and supervisors are paying greater attention to environmental and social risk management – or ESG risk management if you prefer the term. Not that they didn't care about the issue before. However, **regulators are sending mixed signals**. In one Asian country, some regulators recently asked banks not to exclude companies based solely on environmental and social risks. Conversely, others were more interested in finding out how leading banks were approaching the issue.

What *has* changed is that **regulators are issuing increasingly detailed guidance and providing their own definitions of what they expect** – or may soon expect – of banks and insurers. In 2019, the EU issued **rules** on how asset managers and financial advisors must disclose ways in which investors may be exposed to sustainability risks that are material for them ("outside-in perspective"), and how these may be linked to the adverse effects they may have on the parties concerned and the environment (**outward-facing or "inside-out" risk perspective**). And in 2020, the EU published its EBA ***Guidelines on Loan Origination and Monitoring***, which require ESG factors to be considered.

In its June 2021 report, the EBA proposes a comprehensive approach to ESG risks being included in the regulatory and supervisory framework for credit institutions and investment firms. It also suggests how supervisory authorities should assess institutions' ESG risk management. The EBA's goal is to assess the resilience of institutions' business models and risk management systems against ESG-related challenges across different time horizons, including physical climate and environmental risks, emerging public policies, and broader transition trends.

While some regulators have chosen **principle-based approaches** – which bring their own set of challenges because they leave it to financial institutions to figure out what is expected of them – **recent EBA publications have pointed to a new direction for ESG supervisory expectations. Detailed information on terminology, processes, and methodologies is now required**. Regulators have historically tended to share knowledge among market participants. Now, however, it is these actors who are creating the norms applied by regulators and supervisors when they evaluate how financial institutions address ESG risks in their respective jurisdictions.

This shift will have consequences for all financial institutions. While laggards or less exposed institutions will have to improve their ability to handle these issues, leading institutions will also have to ensure that their systems meet regulatory and supervisory expectations. This is a major reset that is very similar to what the EU Sustainable Finance Disclosure Regulation is creating. **What had been regarded as advanced practices are suddenly becoming mere baseline expectations** (a huge challenge for late movers). And just like in the boardgame, **Monopoly**, even the more advanced institutions may well find themselves being sent back to Start.

As the fog lifts on the road ahead, the contours of the future are emerging. Banks, asset managers, and other financial institutions will need not only to introduce procedures to assess and report on ESG risks and opportunities, but will also have to **apply the definitions and approaches stipulated by regulatory and supervisory authorities** when doing so. As ESG is still comparatively new territory for regulators and supervisors, ensuring that the journey progresses smoothly will require constructive interaction between the financial industry and authorities.

Olivier Jaeggi and Bruno Bischoff

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International standards

Updates on cross-sector environmental and social standards that might be relevant as benchmarks for risk assessments.
Scope: key developments related to the most important international environmental and social standards.

→ London Declaration commits to overhauling international standards for sustainable finance

To accelerate the transition to net zero, members of the International Organization for Standardization (ISO) have made an unprecedented pledge to upgrade standards for green finance. With three quarters of the world's companies failing abysmally to meet basic climate-change targets, the London Declaration (led by the British Standards Institution) has committed all 163 ISO national standards bodies representing 165 countries to embed key climate considerations into every new standard that is either created or revised. The pledge reinforces ISO's recent release of a new and exhaustive set of standards to help define what is truly "green" finance. Their environmental performance evaluation provides a global four-part roadmap for issuing a green bond and originating a green loan (ISO 14030). ISO has also released the first uniform glossary of terms and definitions for the sustainable finance industry (ISO/TR 32220).
September 24, 2021

Read more (1) → Read more (2) → Read more (3) → Read more (4) → Basic concepts →

What we're watching

Below, you will find a few **insights from our Policy Outlook research**. ECOFACT's team of legal analysts continuously monitor regulatory developments related to sustainable finance and corporate responsibility. Monitoring includes 50 jurisdictions, the European Union, financial sector regulators, stock market authorities, as well as multilateral organizations such as the OECD and the UN. For more information on regulatory trends, please **contact us**.

Jurisdiction	Date	Description
EU	By December 31, 2021	The EU Commission will present the final text of the proposed Directive on Corporate Sustainability Reporting. **Read more** (for Policy Outlook subscribers) →

Selected open consultations

We have selected a few **open consultations from our Policy Outlook database** that are relevant to the wider financial/ insurance industries. Many organizations and governments use a consultation process to solicit structured feedback from stakeholders. It is an opportunity for interested parties to comment on the materials that are issued to support dialogue. For further information on open consultations, please **contact us**.

Authority	Consultation topic	Deadline for input
US Department of Labor (DOL)	The US DOL is accepting feedback on a proposed rule under the Employee Retirement Income Security Act (ERISA). The rule clarifies that fiduciaries are allowed to consider climate change and other ESG factors when making investment decisions and when exercising shareholder rights. **Read more** (for Policy Outlook subscribers) →	December 13, 2021

Source: ECOFACT's Policy Outlook, a database of in-depth analyses of sustainable finance and corporate responsibility regulatory initiatives across the globe.
More information: **https://www.ecofact.com/policyoutlook/**

High-risk sectors

Developments relevant to six specific high-risk sectors, such as news on risk factors and trends, associated regulations, and best practices. This section concludes with a two-page table that provides an update on sector-related controversies, reveals financial institution exposure, and shares ECOFACT analyses.

Oil & Gas Mining Forestry Agriculture Utilities Chemicals Other

Risk factor

Human rights becoming lost in ESG considerations

Viewing ESG considerations merely as factors that affect value creation and financial returns could jeopardize the outcomes desired by investors and society as a whole. Aggregating ratings from all three elements (E, S, and G) means that some companies receive strong ESG ratings overall, even if they, for example, fall short on human rights. NGO Business for Social Responsibility suggests that the companies' ESG focus appears to be steered by shareholders rather than the voices of the people affected by their operations. September 23, 2021

Read more

Risk factor

Oil and gas firms seeing government scrutiny and fighting back in court

A World Benchmarking Alliance (WBA) study has determined that the combined emissions of 100 oil and gas companies will probably swallow 80 percent of the world's carbon budget. This means that the sector will exhaust its carbon budget by 2037, when it is supposed to last until 2050 under a Paris Agreement 1.5°C scenario. None of the companies analyzed has announced any intention of ending exploration. There is growing scrutiny of the sector's contribution to climate change.

The *New York Times* has reported that US Democrats are exploring the idea of taxing major oil and gas companies in order to help cover the costs of climate-change-related disasters, and the US House Committee on Oversight and Reform has opened an investigation into climate disinformation on the part of the fossil fuel industry. However, the industry appears to be combatting the way climate policy is affecting their operations (and profits). Oil and gas companies in Canada, Germany, Slovenia, and Italy are bringing cases against governments to the World Bank's International Centre for The Settlement of Investment Disputes, collectively looking for reparations of USD 18 billion. September 24, 2021

Read more (1) Read more (2)
Read more (3) Read more (4)
WBA analysis

Risk factor

Renewables sector presents a human rights challenge

The renewable energy sector continues to be called out for its association with human rights violations in supply chains. According to the Business & Human Rights Resource Center, abuse of workers in this sector appears to be concentrated in Latin America, which accounts for 61 percent of recorded cases worldwide. A Helena Kennedy Centre for International Justice report discusses the use of Uyghur forced labor in global solar supply chains; the Uyghur region supplies about 45 percent of solar-grade polysilicon. Investors in this sector must figure out how to place greater emphasis on their social considerations to improve conditions for renewables workers. September 23, 2021

Read more (1) Read more (2)
BHRRC report HKCIJ report

Risk factor

Financial institutions support global treaty on plastic pollution; toxins in plastic a problem

A new study by the ETH Zurich has increased our understanding of plastic toxicity: plastics release more poisonous chemicals throughout their lifespan than originally believed. Plastics' toxicity and pollution of the environment cost society: USD 3.7 trillion in 2019, projected to be USD 7.1 trillion by 2040 if no action is taken, according to a WWF report. Swedish researchers have advised that plastic pollution is a "global threat," which may be irreversible unless drastic policies are adopted.

When 20 financial institutions representing EUR 3 trillion in assets under management announced support for a treaty to deal with plastic pollution, they joined more than 100 UN member states calling for the same. The UN is also considering another treaty that would ban a toxic, bioaccumulating constituent of plastic packaging (UV-328); the Swiss government presented a motion to the Stockholm Convention to ban or limit the chemical, which if it went through would be seen as "the beginning of the end for plastic." September 6, 2021

Read more (1) Read more (2)
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Call for treaty WWF report
Study 1 Study 2

High-risk sectors

Information based on SIGWATCH data

SIGWATCH scans the messaging of more than 10,000 NGOs around the world on a daily basis in order to identify active and emerging campaigns and issues, tracking the criticism (and occasional praise) of corporations and industry sectors. This qualitative and quantitative data provides a unique insight into NGO concerns, and serves as early warning of the problems that companies and investors will have to manage in the months ahead.

Analysis combines SIGWATCH data and ECOFACT insight

The circles next to each subsector indicate the degree of reputational risk to financial institutions (FIs) that is associated with investments in that subsector.

- ● (red) = High
- ● (orange) = Enhanced
- ● (yellow) = Moderate

Sector & subsector

Level of controversy — Number of NGO campaigning actions per quarter and trend in the last three months[1].

FI exposure — Share of NGO actions criticizing FIs in last 5 quarters

Selected news highlights and ECOFACT risk summary — We have hand picked news stories and reports that highlight specific ESG risk-related issues these sectors were associated with in the previous quarter. Whether the stories target a small element or a large-scale impact of a sector, all share one thing in common: they are relevant to FIs as they assess the evolving risks of these areas of business.

Sector	Subsector	Risk	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	Trend	FI exposure	Selected news highlights and ECOFACT risk summary
Mining	Impact on Indigenous people	High	38	21	31	40	24	↘ 40%	2%	**Mining threatens Indigenous groups:** A rush of illegal mining in Venezuela's protected areas is linked to human rights violations and environmental damage. In Brazil, the government has introduced a bill that would legalize mining on Indigenous lands without community consent. Such legislation would violate the UN Declaration on the Rights of Indigenous Peoples. The UN has issued a report that outlines the gaps in how free, prior, and informed consent is being implemented (or not) around the world.
Oil & Gas	Oil sands	High	5	5	3	1	0	→	0%	**More insurers refusing to cover oil sands pipelines:** An August 2021 tally indicated that 15 insurers have now committed themselves to refraining from insuring or reinsuring Canada's Trans Mountain oil sands pipeline. A Canadian regulator allowed TC Energy to keep the insurers of its oil sands pipeline secret in order to combat the industry's avoidance of the sector. In an open letter, 15 investors asked insurers to avoid the Trans Mountain line. Meanwhile, one of the pipeline's key insurance policies expired on August 31.
Agriculture	Deforestation from agriculture	High	94	83	64	73	60	↘ 18%	8%	**Back government deforestation initiatives rather than plant new trees:** Supporting government-led forest protection efforts that avoid deforestation holds greater value than carbon offsets used to plant trees. A white paper makes the case for developing mechanisms for companies to support government-led tropical forest conservation, which would tap into private-sector funding and could help fill gaps in the carbon market. It is suggested that this approach could bring more benefits to local communities and better address the drivers of deforestation.
Utilities	Gas-fired power	Enhanced	87	106	97	108	104	↘ 4%	4%	**OPEC blames gas shortages on lack of investment:** The head of the Organization of Petroleum Exporting Countries (OPEC) believes that "hysteria" is the cause of an excessively rapid shift away from fossil fuel investment. Spiking natural gas prices as winter approaches do not bode well for public support when it comes to abandoning gas. The world lacks a viable, non-disruptive plan to transition to renewable energy. JPMorgan warns that the world is grossly underestimating the funding and behavioral changes required to revamp the global energy system.
Utilities	Hydropower	Moderate	28	13	20	22	26	↗ 18%	3%	**Hydropower sustainability certification standard released:** The hydropower sector now has an international standard that allows projects to be certified for ESG performance. Projects can qualify for a Certified Sustainable Hydropower label that is aligned with green bond requirements, the EU Taxonomy, as well as World Bank and IFC performance standards. The WWF has noted, however, that the standard is insufficient to protect rivers and biodiversity in Europe because the continent is "already saturated" with hydropower. Europe's 9,000 planned hydropower projects, sustainable or not, will compound any negative impact.

[1] The green/red arrows indicate that the number of NGO campaigning actions have decreased/increased by more than three actions compared to the previous quarter, whereas the orange arrows indicate this change is less than three actions. The percentages below the arrows denote the trend compared to the previous quarter, i.e. the percent change in of the number of NGO campaigning actions.

Emerging risks

Risks that may become material in the near future or are relevant when looking into a company's business model, but are not yet considered as highly significant risks from a financial institution's reputational risk perspective, or are not related to a high-risk sector.

➔ ESG and net-zero claims under the microscope

As new rules such as the EU Sustainable Finance Disclosure Regulation come into effect, regulators are warning the financial industry that they intend to investigate the credibility of ESG claims and net-zero commitments, and that they will take action when these claims are misleading. Both the US Securities and Exchange Commission and Germany's financial regulator BaFin opened investigations into Deutsche Bank's DWS after allegations were raised that it had misrepresented its sustainability claims. The Dutch securities regulator determined that almost half of the 100 investment funds claiming sustainability objectives that it examined did not actually have this focus. Nor did the investment funds publish detailed disclosures on these characteristics. Australia's securities regulator has also indicated that it is watching net-zero claims and will act if these are deceptive. A report published by InfluenceMap concludes that more than half of the 723 equity funds it has investigated do not align with the Paris Agreement goal, despite using descriptive words such as "low carbon," "clean energy," and "energy transition." [See this issue's ***Sector in Focus***.] September 20, 2021

Read more (1) ➔ Read more (2) ➔ Read more (3) ➔ Read more (4) ➔ Read more (5) ➔ Report ➔

➔ Neurotechnology necessitates adjustments to our human rights frameworks

Research aimed at improving our understanding of brain structure and processes is developing rapidly, as exemplified by US company **Neuralink**'s work with implants that connect the human brain to computers. As science begins to unlock the potential of this organ, ethicists are raising the alarm that there is a regulatory desert when it comes to technologies that interface with brains. "Anticipatory governance" should be developed to prevent misuse and harmful modifications. All a person's thinking, "perception, memories, imagination, emotions, decisions, [and] behavior" are tied to the circuitry of their brain. "Neurorights" need to be embedded in existing human rights frameworks or new frameworks purposely developed to sufficiently protect cognitive liberty, mental privacy, mental integrity, and psychological continuity, says Dr. Marcello Ienca of the ETH Zurich. October 7, 2021

Read more ➔

➔ Technology sector's carbon footprint will soon be closely scrutinized, warns KBI Global Investors

Technology companies may soon overtake the energy sector on Climate Action's top 100 polluters list (CA100+), warns David Hogarty, KBI's Head of Strategy Development. The sector has been popular with green investors because of reportedly low direct emissions and renewable energy commitments. However, once Scope 3 emissions are also factored into assessments, Hogarty warns that big tech holdings may emerge as some of the world's largest carbon emitters. Scope 3 refers to indirect emissions generated by using (not manufacturing) products such as phones and computers, related software, and streaming media platforms: the cloud's storage and power demands effectively translate into high-carbon emissions. Technology companies have been accused of underreporting indirect emissions – partly because they are difficult to quantify. However, that situation may soon change. August 3, 2021

Read more ➔

Business case

Information that underlines the business case for environmental and social risk management in financial institutions.

➔ ESG emerges as a driver of global litigation cases

Spurred by the growth of climate-related stewardship concerns, ESG issues previously linked to climate change actions are gaining independent traction. ESG-focused lawsuits against international ventures are increasing across various asset classes and multiple jurisdictions. Global firms tend to handle these cases according to the rules of the jurisdiction in which the cases are filed. This can complicate the way cases develop; cases settled in the US, for example, may still escalate in other jurisdictions. Bearing in mind the growing numbers of class actions on ESG and event-driven securities, responsible investors are advised to manage securities-related litigation risks actively within their portfolio. September 23, 2021

Read more ➔ Report ➔

Peer approach

New sector and issue policies that financial institutions have recently adopted. The table on page 16 gives an overview of the number of sector and issue policies produced by insurers. This issue's policy sector in focus is: Coal (page 17).

➔ Global insurers form action alliance to speed up net-zero emissions, partner to design a standard way of measuring and disclosing insured GHG emissions

- Eight major global insurers and reinsurers have launched the UN-convened Net Zero Insurance Alliance (NZIA). AXA, Allianz, Aviva, Generali, Munich Re, SCOR, Swiss Re, and Zurich Insurance Group announced the move at the recent G20 Climate Summit in Venice. NZIA's members pledge to transition their insurance and reinsurance portfolios toward net-zero greenhouse gas emissions by 2050. This will primarily be accomplished by means of science-based interim targets, each with a five-year interval. Members must report their progress against these targets. NZIA has committed to joining the Glasgow Financial Alliance for Net Zero and the UN Race to Zero, alongside the Net-Zero Banking Alliance and Net-Zero Asset Owner Alliance. July 11, 2021
- Partnership for Carbon Accounting Financials (PCAF) is working with the UN-convened Net-Zero Insurance Alliance (NZIA) to develop a standard way for the (re)insurance industry to measure insured greenhouse gas (GHG) emissions. It is hoped that the standardized methodology will help insurers to set net-zero targets for their underwriting portfolios and acquire greater understanding of their climate impact. PCAF has already issued a similarly targeted **standard** for financial institutions to assess and disclose their financed GHG emissions. September 6, 2021

Read more (1) ➔ Read more (2) ➔ Read more (3) ➔

➔ Sector and issue policies adopted by insurers

NEW in this issue: expanded policy coverage. This chart presents the number of the nine **global systemically important insurers** that have a public policy, guideline, or commitment for investing in or underwriting for the sectors listed in the left column.

Sector policies	I	U
Defense	5	1
(incl. controversial weapons)		
Cluster munitions	6	1
Nuclear weapons	4	1
Chemical weapons	5	1
Agriculture	2	1
Animal welfare	2	1

Sector policies	I	U
Energy		
Oil and gas	1	1
Arctic drilling	1	1
Oil sands	3	1
Utilities		
Nuclear power	1	1
Coal-fired power plants	6	3

I = investment in the sector has a policy, guideline, or commitment

U = underwriting for the sector has a policy, guideline or commitment

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Policy sector in focus: Climate

➔ Accusations of greenwashing and a crackdown on climate claims

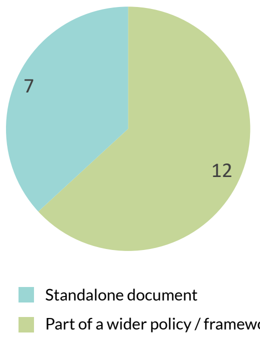
As FIs move to develop and publicize climate commitments and policies, regulators such as the **UK Financial Conduct Authority** and the US **Securities and Exchange Commission** are **reminding** the sector that climate and **ESG claims** must be truthful and verifiable, and that the information in their financial and non-financial disclosures is expected to align.

Media outlets are reporting allegations of FIs deceiving clients and policy makers about the "**greenness**" of their products, services, and climate claims. Meanwhile, banks' net-zero climate pledges are **called into question** because of a discrepancy between their climate promises and their business activities, for example backing the **bond offering** of a Russian thermal coal producer and exporter when you have a public "net zero by 2050" pledge. The **Australian securities regulator** has said it is specifically watching for misleading net-zero claims.

Why we think it matters: Besides leading to reputational risks, being linked to greenwashing practices can also involve material, legal, and liability risks.

Ever since the Task Force on Climate-related Financial Disclosures (TCFD) released its recommendations in 2017, some FIs have considered climate change a potential financial risk – not only to their own operations, but also to those of their clients. **Our analysis** of 19 FI climate change policies shows the majority of FIs to have a climate change policy/statement. (*See charts below.*)

Type of policy



All 19 FIs surveyed have a public climate change policy/statement.

> *"Finance alone cannot solve the climate threat. This is ultimately a question of every group making significant and sustained steps to cut emissions."*
>
> **Andy Howard,** Head of Sustainable Investment, Schroders

New tools and databases

This section presents new tools and databases that can help to identify or manage environmental and social risks.

Stress testing: limits, advances, and references

Stress testing to evaluate resilience in different climate scenarios is growing in popularity. Supervisors are evaluating economies; institutions are examining their own operations through different lenses. Here are some noteworthy developments:

- The Financial Stability Institute of the Bank for International Settlements (BIS) has published an **insights paper** that compares different ways of stress-testing banks for climate change. It looks at the challenges of and approaches to modelling, noting that adapting stress tests to banks' climate-related risks raises specific challenges. The paper presents the results of a review of three pilot exercises. July 6, 2021
- In its ***Limits of Stress-test Based Bank Regulation*** working paper, the BIS presents a theoretical framework that looks at how accurately stress tests predict banks' future behavior. One of the paper's conclusions is that the less accurate assessments are, the more banks' risk-taking is amplified. July 6, 2021
- **Paris Agreement Capital Transition Assessment (PACTA) for Banks**, the open-source scenario analysis toolkit, has added the aviation sector and three new climate-change scenarios. Data for all sectors has also been updated (Q4 2020 PACTA for Banks) and a new PACTA for Banks software package released. July 8, 2021
- Taking stock of scenario-based climate risk measurement (SCRM), the Institute of International Finance has published ***Navigating Climate Headwinds: Reference approaches for scenario-based climate risk measurement by banks and supervisors***. It examines the risk of regulatory fragmentation if supervisory exercises are based on different approaches. The report makes suggestions on how to achieve greater global alignment between prudential authorities' SCRM exercises. July 15, 2021
- The European Central Bank has shared the **results** of its economy-wide climate stress test, indicating that climate change will severely affect firms and banks if climate risk issues are not addressed. Investment in heavily exposed sectors will be affected the most. September 22, 2021

Read more (1) → Read more (2) → Read more (3) → Read more (4) → Read more (5) →

ILG report helps investors understand fund climate performance and proposes "temperature score" as a metric

The proposed Sustainable Investing Framework relies on reported Scope 1 and 2 greenhouse gas emissions as the base metric for communicating climate stability. In a two-part report, the Cambridge Institute for Sustainability Leadership's Investment Leaders Group (ILG) analyzes how current approaches measure and report investment funds' climate performance. It also makes the case for using a universal temperature score that is outcome-based and would potentially better indicate if an investment is in alignment with the Paris Agreement goal. July 29, 2021

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About ECOFACT

ECOFACT has addressed the risks and opportunities that ESG issues present to the financial sector since 1998. We work primarily for banks, insurers, institutional investors, and international standard-setters. Helping our clients to improve their understanding of credit, reputational, compliance, and liability risks in the context of sustainability ESG issues and responsible business conduct is our specialty. **Contact us** today to explore how our unique advisory services and market-leading research can assist you.

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The Policy Outlook platform

A continuously updated **analysis of regulatory changes** pertaining to sustainable finance and corporate responsibility.

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Research

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Our global, **comprehensive analysis of financial institutions' and insurers' ESG policies** across more than 20 sectors and issues.

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ECOFACT can work with you in different ways:

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Receive support to **design, revise, and implement processes** anchored in your existing routines and compliance culture.

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A new and innovative approach to regulatory implementation: a **network of financial institutions shares the costs and benefits of our services.**

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- design **workflow tools** that enable cost-efficient, consistent, and rule-based decision-making tailored to your risk appetite
- conduct **risk assessments** and **portfolio screenings**
- **track** and **communicate results**

Learn more →

ECOFACT is a signatory to the *United Nations Global Compact* and the *Principles for Responsible Investment*, and a member of *Swiss Sustainable Finance.*

Swiss Sustainable Finance   THE GLOBAL COMPACT WE SUPPORT   PRI Principles for Responsible Investment

About this report

The *ECOFACT Quarterly* report is tailored to the needs of individuals and teams in charge of assessing and controlling environmental and social risks in corporate banking, investment banking, and commercial insurance. It aims to provide an update on risks, standards, tools, and best practices that are relevant primarily from a reputational risk perspective.

Content selection is a team endeavor that considers the applicability of the information to environmental and social risk, that it was published (in most cases) in the previous quarter, and that it holds relevance for financial institutions from a reputational risk perspective. The scope covers the 10 principles of the UN Global Compact.

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