ESG RISK QUARTERLY

ECOFACT's briefing for risk experts

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ECO:FACT

Table of contents

Editorial

Now it is the board of directors' turn

The time when sustainability was just an issue for subject matter experts, intrinsically motivated staff, and middle management is over. And that's a good thing. As much as these courageous attempts achieved, without the backing of the entire organization their real-world impact remained limited.

For as long as sustainability was not a strategic matter, senior management and boards of directors took little interest. At the top level, some individuals did care and engage on these issues, often driven by concerns about the firm's adverse impacts on society, reputational risk, and the global risks to future generations. Alongside internal sustainability advocates, they did help to establish their companies as the sustainability leaders in their industries.

Sustainability and other ESG issues are now undeniably of strategic importance. Just have a look at **HSBC**. The global bank has identified the transition to a net-zero carbon economy as one of its four strategic pillars. To be clear, it is not talking about its sustainability strategy, but its business strategy overall. Such a decision obviously could not be made without the involvement of HSBC's board of directors.

Today, involving the board is not an option — it's an obligation. In many jurisdictions new regulations provide further details of what the new board duties comprise (ECOFACT Policy Outlook users can access our recent briefing **here**). They can be summarized as follows:

- Oversee the identification and prioritization of ESG risk factors that can affect the company's revenues, its long-term success, and shareholder returns
- Supervise the identification and prioritization of ESG-related adverse impacts that result from the company's business activities, or those of third parties with which the company maintains business relationships
- Consider ESG factors and the requirements included in ESG regulations when developing corporate strategies
- Ensure that sustainability-related information is included appropriately in the relevant reports
- Manage the integration of ESG-related risks into risk management policies and frameworks, as well as their implementation
- Direct the application of environmental and human rights due diligence frameworks

Of course, for many directors this presents new challenges, as they lack the knowledge and the experience to work on ESG strategies. Providing them with helpful and digestible information is therefore essential.

In the briefing, my colleague offered a very good rationale for why these duties have become so crucial. Considering the correlation between ESG performance and company valuation, boards of directors have much to reflect upon. And she adds, as the scope of ESG issues grows, so too do board responsibilities.

Olivier Jaeggi

Complementary Policy Outlook trial

Did you know we offer free, 30-day trials of **Policy Outlook**? This tool is the world's largest and most comprehensive database on sustainable finance and corporate responsibility regulations. ECOFACT monitors regulatory initiatives in more than 50 countries and the European Union, delivering in-depth analyses of developments in jurisdictions responsible for nearly 85 percent of global GDP. **Start your trial now**.

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.

→ New UN resolution on a healthy environment and historic climate ruling by Brazil's Supreme Court

The United Nations General Assembly has declared a healthy environment a human right for everyone on this planet. While not legally binding on the 193 UN member states, the **resolution** is one of many international declarations designed to help people hold their national governments more accountable on environmental protections. In a related development, the Brazilian Supreme Court recognized the Paris Agreement as a human-rights treaty that trumps national law. As a result, the country's government must reactivate its climate action fund, which was originally set up in 2009 but has been inoperative since 2019. Advocates are hopeful that these groundbreaking human rights developments will catalyze more ambitious climate action and transformative environmental justice. July 28, 2022

Read more (1) → Read more (2) →

→ EU taxonomy nuclear and gas decision attracts challenges

The EU's **inclusion** of natural gas and nuclear power in its green taxonomy has provoked the ire of civil society organizations – and some EU member nations. Five civil society organizations, including the WWF European Policy Office, **resigned** from the European Commission's Platform on Sustainable Finance, saying that the Commission had ignored the recommendations of its expert group, particularly regarding the inclusion of gas and nuclear power in the taxonomy. This has damaged the taxonomy's credibility, according to the organizations, who also said they had lost faith in the process. Luxembourg and Austria are challenging this development in the courts, with Austria calling the law essentially a "greenwashing" of fossil fuels, while a dozen environmental organizations are **challenging** the inclusion by requesting an internal review. September 14, 2022

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

Open consultations

Our **Policy Outlook database tracks open consultations** that are relevant to the wider financial and insurance industries as well as corporate actors. Organizations and governments solicit structured feedback from stakeholders during these events. Interested parties can comment on the materials that are issued to promote dialogue. Please **contact us** for more information on open consultations.

Authority	Consultation topic	Deadline for input
Climate Bonds Initiative	The **draft** of version 4.0 of the Climate Bonds Standard and Certification Scheme aims to expand the standard's structure, enabling the certification of non-financial corporates and the sustainability-linked bonds they issue. **Read more** (for Policy Outlook subscribers) →	November 4, 2022
Principles for Responsible Investment (PRI)	The PRI is running a two-part **consultation** on the topic of "PRI in a Changing World." It is requesting signatory input on the initiative's value, vision, mission, and purpose. **Read more** (for Policy Outlook subscribers) →	January 2023

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/**

Spotlight: ESG investing under fire – is the business case still relevant?

A deeper dive into news, issues, or developments that have received significant attention in the past quarter. We also explain why we think the topic is important to your work.

→ ESG investing has come under fire. The third quarter of 2022 was marked by a flurry of backlash against this approach. Sentiments ran high: politicians' anti-ESG efforts were labelled as political "interference with the free market," and even an American comic creator joined the critics. One company launched a new "anti-ESG" exchange-traded fund under the banner of "excellence capitalism."

Some politicians, particularly Republican officials in the USA, view an ESG-first approach as a potential violation of the prudent investor principle; they assert that ESG consideration steers investment away from high returns and rewards underperformers.

US states such as Texas and Idaho are using their newly passed anti-ESG laws to divest state funds from financial institutions that "boycott" fossil fuel companies. Some appear to reference institutions' public ESG-related ratings, policies, and data to identify violators.

Why we think it matters

Some criticism leveled at ESG investing is valid, but as a whole omits essential points. The anti-ESG movement is likely to be short-lived because authorities and regulators (such as the Federal Reserve and the European Central Bank) recognize the risks that climate change and other environmental concerns pose to the financial system. This makes ESG consideration a matter of fiduciary duty. There is also an indication that "red states" pay a premium when issuing municipal bonds, as major underwriters are leaving these states.

The ESG debate heats up

Resource	Offered by	Description
The Truth About ESG and Sustainable Investment	US Forum for Sustainable and Responsible Investment	Website: Proponents of sustainable investing give 10 reasons why the approach is necessary and must be pursued.
A broken system needs urgent repairs	The Economist	Article: This eight-part special report highlights perceived failings of ESG investing.
One Fund, Three Names and Lots of Questions for "ESG"	Bloomberg	Article: What is it that makes an investment "sustainable"? Is it all in the fund's name, and why do these names keep changing?

High-risk sectors

News on risk factors and trends, regulations, and best practices associated with key high-risk sectors.

Oil & Gas Mining Forestry Agriculture Utilities Chemicals Other

Risk factor

Historic drought severely affects most sectors of the world's economy

A disturbing theme of the third quarter of 2022 was widespread drought conditions that touched many economic activities around the world. Blamed on climate change, the lack of water or high prices for available water is affecting agriculture, power generation, manufacturing, shipping, mining, and other industries. The high temperature and low flow of water reduces oxygen levels, which also affects fish and wildlife. The European Commission's science and knowledge service predicts that these conditions will continue in the western Euro-Mediterranean region at least until November. Scientists say climate change triggers erratic weather, which is making water supply increasingly unreliable. A May 2022 report calculates water-related risk for the financial sector at USD 225 billion and exhorts institutions to identify, assess, manage, and disclose water risks across portfolios and loan books. August 23, 2022

Read more

Risk factor

Voluntary standards in extractive industry not enough for human rights; environmental risks

Voluntary human rights and environmental due diligence standards in the raw materials industry are insufficient, according to a new report from Germanwatch. The organization examined seven voluntary standards for the raw materials sectors, including the Copper Mark, the London Metals Exchange, the Responsible Steel Initiative, and the Voluntary Principles on Security and Human Rights standards, and found that all fell short. None of the standards ensure compliance. They all lack transparency, independence, and right-holder access and involvement with audits. Grievance mechanisms and corrective action plans are also inadequate, and adherence to the UN's Guiding Principles on Business and Human Rights is patchy. The study's authors state that minimum legal requirements are necessary if companies are to meet due diligence standards. July 4, 2022

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Risk factor

Turbulence ahead for wind power?

Offshore wind power may have unintended consequences: researchers have found that deep-water wind turbines on the continental shelf, which could provide 80 percent of wind power in the future, may disrupt vital ocean processes. The turbines could create turbulence that alters the life cycle of phytoplankton, in turn damaging ocean food webs. Their conclusion: more study needed. Moreover, climate change itself could make wind turbines less useful. Researchers have found that surface winds appear to be slowing in a "great terrestrial stilling." As the polar regions of the earth warm faster than other regions, the global temperature differential is reduced, resulting in weaker winds. Aside from the impact on power generation, wind stilling could lead to worse droughts, more intense winter storms, and worsening wildfires. September 12, 2022

Read more (1) Read more (2)

Risk factor

Swiss cement company Holcim faces Global South legal challenge

Under the banner of the "Call for Climate Justice" campaign, four fishermen have filed a historic request for arbitration (the first step in Swiss civil proceedings), seeking damages and emission reduction from the Swiss cement company Holcim, a leading global manufacturer of cement. Holcim is one of the 50 biggest corporate CO_2 emitters worldwide. The case asserts that Holcim should take responsibility for its contributions to climate change. Large portions of Pari, the plaintiffs' small Indonesian island, are expected to be under water within 30 years. Locals are already challenged by increased flooding and find themselves facing enormous costs. Courts have yet to decide the extent of individual corporate responsibility for the global crisis. July 13, 2022

Read more (1) Read more (2) (German)

High-risk sector controversies

This table shares SIGWATCH data on NGO campaigns and financial institutions' exposure to criticism from NGOs. It also provides ECOFACT-curated links to sector-related controversies from the last quarter as well as our risk rating.

Sector & subsector		Level of controversy: Number of NGO campaigning actions per quarter in the last five quarters — 2021 Q3	2021 Q4	2022 Q1	2022 Q2	2022 Q3	FI exposure: % share of NGO actions criticizing FIs (SIGWATCH data)	ECOFACT risk rating	Noteworthy news
Forestry	Logging and plantations	130	122	85	73	95	13%		Report reveals that some toilet paper manufacturers continue to source from the boreal forest; offers sustainability scorecard for brands. Read more
Mining	Coal mining	40	39	26	26	25	39%		Coal prices set 10-year records as energy supply strained; despite a decline in coal use, consumption is expected to increase. Read more
Mining	Mining impact on Indigenous people	24	21	19	24	19	9%		Industrial unions ask Brazilian president to withdraw from the ILO Indigenous and Tribal Peoples Convention of 1989. Read more
Agriculture	Palm oil	27	23	27	24	27	9%		Few companies sourcing palm oil from Indonesia use third-party verification to ensure that supply is deforestation-free. Read more
Agriculture	Livestock agriculture	183	194	173	138	79	8%		Asked to cut livestock numbers to meet climate and nitrogen targets, farmers say their operations will not be profitable. Read more (1) Read more (2)
Agriculture	Deforestation by agriculture	66	81	46	47	46	24%		Over 90 percent of tropical deforestation is linked to agriculture; there is a need to understand causes, states report. Read more

ECOFACT risk rating

After weighting the level of controversy associated with each subsector, ECOFACT assigns a risk rating of either **red** (high risk), **orange** (enhanced risk), or yellow (moderate risk). The rating reflects our assessment of the degree of reputational risk that financial institutions (FIs) face when investing in the sector.

About SIGWATCH

SIGWATCH scans the messaging of more than 10,000 NGOs around the world every day, identifying active and emerging campaigns and issues, and tracking the criticism (and occasional praise) of corporations and industry sectors. This qualitative and quantitative data offers unique insights into NGO concerns and gives early warning of the problems that companies and investors will have to manage in the months ahead.

Emerging risks

Risks that could be relevant when looking into a company's business model. These issues may not yet be considered highly significant, but they have the potential to be.

Climate change's impact on the economy probably worse than previously believed; financial stress-testing climate models and standards need to change, say researchers

A recently published **study** makes the case for considering bad-to-worst climate-change scenarios, calling this "integrated catastrophe assessment," and pointing out that the extreme consequences of anthropogenic climate change are "dangerously underexplored." With several of the earth's systems near tipping points, we appear to be underestimating risk, and this spills over to risk-modeling in the financial system. Other researchers **looked** at climate scenarios used by the financial industry, concluding that top-down approaches are flawed "at a granular scale." They warn against adopting these approaches – such as the Network for Greening the Financial System methodologies – in isolation, and caution against them evolving into industry standards. They promote the addition of bottom-up assessments alongside top-down ones in order better to capture material risk. September 29, 2022

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

Growing environmental costs of crypto-mining under scrutiny

A recent **study** published in *Scientific Reports* shows that cryptocurrency and blockchain "mining" is as environmentally damaging as beef farming, uses as much electricity as Austria, and is becoming more carbon-intensive. Given these environmental costs, the industry is facing increasing scrutiny. In the United States – host to a third of the world's crypto operations – Democratic lawmakers have **called** on the Department of Energy and the Environmental Protection Agency to require that crypto-miners report on their energy use and emissions. The Office of Science and Technology Policy has **recommended** that the US take steps to ensure cryptocurrency doesn't increase power costs or endanger the power grid, while the European Central Bank has also **warned** financial institutions about the climate-associated risks of crypto technologies. September 29, 2022

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

Cyber risk in central banks: study

Increasingly sophisticated cyberattacks are becoming an everyday occurrence. As one of the most consistently attacked sectors, finance is especially at risk. Central banks have developed complex assessments of the frequency and cost of various kinds of cyberattack, according to a Bank for International Settlements **working paper**. A survey of 21 members of the Global Cyber Resilience group has revealed that phishing and social engineering are deemed the most common attacks, while the potential losses of systematically relevant attacks are deemed to be considerable. Most respondents suspect that the sector is underprepared, and they have increased cyber security investments since the pandemic. Central banks also cooperate via a networked coordination center, standard-setting, and shared security projects. September 14, 2022

Read more →

Peer approach

A selection of new sector and issue policies that have recently been adopted or that are receiving attention. This section includes announcements of peer alliances and collaboration.

→ SBA, AMAS: Switzerland takes a self-regulatory approach to sustainable finance – for now

In keeping with Switzerland's traditionally less authoritarian approach to banking regulation, two self-regulatory associations have released recommendations for sustainable finance. At the end of June 2022, the Swiss Bankers Association (SBA) announced guidelines on integrating sustainability criteria into **investment** and **mortgage** advice. Members of the SBA are to meet the expectations starting on January 1, 2023. The Asset Management Association Switzerland (AMAS) has released a principle-based self-regulation framework for asset management. Targeting sustainable financial products, the transparency and disclosure obligations will enter into force for AMAS members on September 30, 2023. Policy Outlook subscribers can access a **briefing** on this topic. September 26, 2022

Read more (1) → Read more (2) →

→ HSBC charts thermal coal exit

HSBC Asset Management has **announced** that it will phase out its investments in thermal coal in the EU and OECD by 2030 and globally by 2040. The decision is in line with HSBC Group's broader strategy of net zero by 2050. Starting immediately, HSBC Asset Management will no longer invest in initial public offerings or fixed-income financing of companies expanding their thermal coal operations, and it will not create new funds with more than 2.5 percent exposure to thermal coal assets. For actively managed portfolios, the transition to no holdings with more than 2.5 percent exposure will occur by 2030. Exceptions will be made for companies with transition plans, but the bank will divest from companies without appropriate transition strategies. September 22, 2022

Read more →

→ Sector and issue policies adopted by insurers

This table presents the number of the **nine global systemically important insurers** that have a public policy or guideline for investing in or underwriting for the sectors listed in the left column.

Sector policy	Q1 2022	
	I	U
Agriculture	**1**	**1**
Agricultural commodities	2	0
Animal welfare	1	1
Palm oil	3	2
Forestry	2	2
Tobacco	5	3
Fisheries	1	1

Sector policy	Q1 2022	
	I	U
Utilities	**1**	**1**
Nuclear power	1	1
Coal-fired power	8	3
Hydropower	0	1
Human rights	**7**	**5**
Large-scale resettlement	1	1

I = sector-related investment activities have a public policy or guideline   U = sector-related underwriting activities have a public policy or guideline

Policy sector in focus: agriculture and climate risk

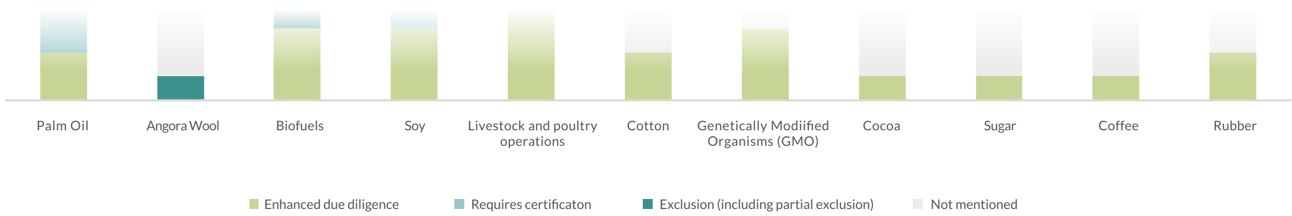
A discussion that highlights why some financial institutions have developed policies to guide their activities associated with a specific sector or concern.

Food shortages caused by extreme weather are becoming more common, forcing us to acknowledge the global agricultural system's vulnerability to climate change. From risotto rice to cotton, from wine to biofuels, as well as the insects that pollinate crops and the waterways that carry them to market, food production is demonstrably affected by (unpredictable) climate extremes. The ranges of agricultural pests are also expanding as winters become milder, which is an added pressure on crop yields.

Why we think it matters: The agriculture industry is believed to be responsible for about one-third of all greenhouse gas emissions. And while financial institutions address certain agricultural products within their environmental and

Financial institutions tend to look at the impact of companies on climate, but to a lesser extent at the risks posed by climate change and nature loss on companies (i.e., double materiality). If agricultural producers fail to adapt to climate change, climate regulation, or consumer preferences, they risk devaluation, making the role of investors and their policies ever more important.

Subsectors addressed in agriculture-related environmental and social risk policies*



*Graph based on data from ECOFACT's Monitoring Peer Policies, a comprehensive analysis of environmental and social policies and frameworks of a variety of leading banks and insurers.

New resources

This section highlights tools, databases, and other information that can help you to identify, manage, disclose, and mitigate ESG risks.

➔ 50 ways to value nature, and other biodiversity-related developments and resources

Noting that the world's economy relies 100 percent on nature's services, a Taskforce on Nature Markets' **report** calculates the annual trade in these markets' goods and services at USD 7 trillion. However, it is hard to apply value to what you cannot measure. To overcome this problem, a group of investors are exploring **bioacoustics** to measure biodiversity and inform their engagement with companies. In other news, the market's "narrow" way of valuing nature is the foundation of the biodiversity crisis, concludes a **mega-review** that goes on to identify more than 50 ways to expand nature valuation in research and policymaking. Finance for Biodiversity has updated its **guide** on biodiversity measurement approaches, which covers seven tools for financial institutions' work. And an **integrated approach** to climate change and nature loss has been rationalized from a financial institution perspective. September 27, 2022

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

➔ New guidance encouraging investor climate action

Climate change finance group the Investor Agenda has issued new **guidance** for investors to create and publish Investor Climate Action Plans (ICAPs) and to help the financial sector achieve net zero by 2050. An ICAP is a tool investors can use to navigate climate-change initiatives; the Investor Agenda's "**expectations ladder**" is a framework for establishing an ICAP that encourages investors to act on the climate crisis by assessing their approach to climate risks and opportunity, developing transition strategies, engaging with stakeholders, and disclosing relevant information. The new guidance offers more detail on how to measure progress through climate action and how to apply an ICAP across core asset classes. It offers sector-level guidance and resources on biodiversity and climate adaptation resilience. July 7, 2022

Read more ➔

➔ OS-Climate launches open-source green finance tools

The Linux Foundation's non-profit venture OS-Climate has released three free analytic tools developed collaboratively with industry to facilitate the shift toward green finance. Led by international banking group BNP Paribas, the **Physical Risk & Resilience Tool** enables non-financial stakeholders to assess the climate resilience of assets. Insurer Allianz has spearheaded development of a **Climate Portfolio Alignment Tool** to help align portfolios with the Paris Agreement target. Finally, the **Transitional Analysis Tool**, developed by aircraft manufacturer Airbus, enables corporations to model, test, and conduct scenario analysis for strategic climate-aligned decisions. This release is the first in a series of open-source tool collaborations designed to encourage climate-friendly decision-making. July 25, 2022

Read more (1) ➔ Read more (2) ➔

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