ESG RISK QUARTERLY

ECOFACT's briefing for risk experts

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ECO:FACT

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Editorial

It's time for more comprehensive sustainability risk management in the financial sector

In my **editorial** for the July 2020 issue of the ESG Risk Quarterly, I argued that it was time for financial institutions to take their sustainability (environmental and social) risk management to the next level. Significant developments in the realm of soft and hard law, as well as the emergence of new supervisory expectations and evolving peer practices prompted me to do so.

Since then, all these pressures have intensified. Many financial institutions are still struggling to run comprehensive sustainability risk management systems. Typically, they face the following challenges:

- Many financial institutions (FIs) cover a restricted range of industry sectors and are failing to broaden their scope to include companies from other sectors that are linked to sustainability risks — such as information technology (e.g. surveillance issues), chemicals (e.g. disaster risk), or other financial institutions (e.g. those with particularly high exposure to controversial sectors).
- They do not cover all relevant business areas — such as general purpose loans, commodity trade finance, or group-level property and casualty insurance (as opposed to insurance cover for specific projects).
- They are not aligning their processes to relevant international due diligence standards, such as **OECD** guidance.
- They are taking a narrow view when assessing risks by mitigating (reputational) risk for the institution in question rather than aiming at mitigating adverse impacts linked to their clients' business activities. To find out why this is an issue, please click **here**.
- FIs may not have effective systems in place. For example, their first-line defense units may not have the necessary expertise or tools in place to assess risks properly — or they are applying solutions that merely tick the boxes.

In the eyes of the public and policymakers, financial institutions are *enablers of business*. For this reason — regardless of how FIs cooperate with their clients — failing to adopt an appropriately comprehensive approach will prevent them from reaping the rewards of sustainable risk management.

At this juncture, I would like to state explicitly that my observations should in no way be seen as a criticism of sustainability risk teams. Despite some growth, teams remain largely understaffed and are therefore unable to perform all the tasks that they should — despite their good intentions, hard work, and long hours. Boards and executive committees are **responsible** for ensuring that sustainability risk management and the related due diligence rules and processes are implemented. Not getting this right will expose FIs to financial risks, legal **liabilities**, and reputational issues – such as greenwashing allegations. It is time to provide sustainability risk units with the budgets they need in order to ensure that institutions manage their sustainability risks appropriately.

Olivier Jaeggi

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.

➔ ISSB finalizes first standards, offers "transitional relief" with one year of climate-only disclosures

The International Sustainability Standards Board (ISSB) has finalized the technical content of two disclosure standards (IFRS S1 and IFRS S2), which it will issue by the end of June 2023, making them effective in January 2024. These will help disclosing entities to adjust to the rigors of the system by requiring only climate-related disclosures (IFRS S1) in the first year – sustainability information may be omitted until the second year. April 4, 2023

Why we think it matters: As the ISSB solidifies its sustainability disclosure standards, other organizations such as the **European Financial Reporting Advisory Group** and the **Global Reporting Initiative** are making progress on their own frameworks. UBS's **annual report** identifies ESG regulation divergence as a top emerging risk, and this concern is not unfounded. Although global harmonization of expectations is an ambitious goal, it is nonetheless an important one for companies.

Read more (1) ➔ Read more (2) ➔

➔ Launch of global ISO sustainable finance standard for transition alignment

The British Standards Institution (BSI) and International Standards Organization (ISO) have released a globally applicable standard to help integrate sustainability principles in financial operations worldwide. With numerous frameworks and regulations operative in different jurisdictions, these universal principles are designed to address this fragmentation and expedite global sustainability alignment throughout the sector. Entitled BS ISO 32210, the standard aims to help financial organizations avoid greenwashing by setting a credible, coherent path to sustainability alignment. Published a few years after BSI released the first UK-based standard for sustainable investment management, BS ISO 32210 sets expectations for optimal governance and culture-wide sustainability policies, recommended investment strategies, risk management, impact assessment, stakeholder engagement, monitoring, and reporting. February 28, 2023

Read more (1) ➔ Read more (2) ➔

What we're watching

Here are a few **anticipated actions revealed by our Policy Outlook research**. ECOFACT's team of legal analysts monitor regulatory developments related to sustainable finance and corporate responsibility in more than 50 jurisdictions, including the EU, and those of financial sector regulators, stock market authorities, and multilateral organizations. Please **contact us** for more information on regulatory trends.

Jurisdiction	What's on our radar	Date of next expected development
European Union (EU)	The EU will formally adopt the first set of General European Sustainability Reporting Standards (ESRS) for disclosures required by the Corporate Sustainability Reporting Directive. **Read more** (for Policy Outlook subscribers) ➔	Q2 2023
Science Based Targets Network (SBTN) SCIENCE BASED TARGETS NETWORK GLOBAL COMMONS ALLIANCE	The SBTN is set to release its first nature-related targets, starting with freshwater and land-based objectives. **Read more** (for Policy Outlook subscribers) ➔	Q2 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: Artificial intelligence – a balancing act

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.

➔ Artificial intelligence (AI) technology is embedded in many financial institutions' day-to-day activities (as well as health care, policing, judicial systems, advertising, education, policy, and more). Reuters research indicates that insurers also invest "heavily" in and make extensive use of AI technology.

Many benefits

A survey has revealed that banks, hedge funds, and trading firms frequently use AI for natural language processing, recommending next-best actions, portfolio optimization, and fraud detection.

It delivers HR services, personalizes customers' experiences, and purportedly de-risks credit services. Among AI's myriad benefits, Force for Good found that it could significantly cut the cost of funding the UN Sustainable Development Goals and bring targets within reach.

Energy use and emissions

Powerful computing is fueled by electricity, and AI uses more power than other types of computing. Training one model expends more electricity than 100 US homes in a year. (Cryptocurrency mining faces similar energy-use criticism.)

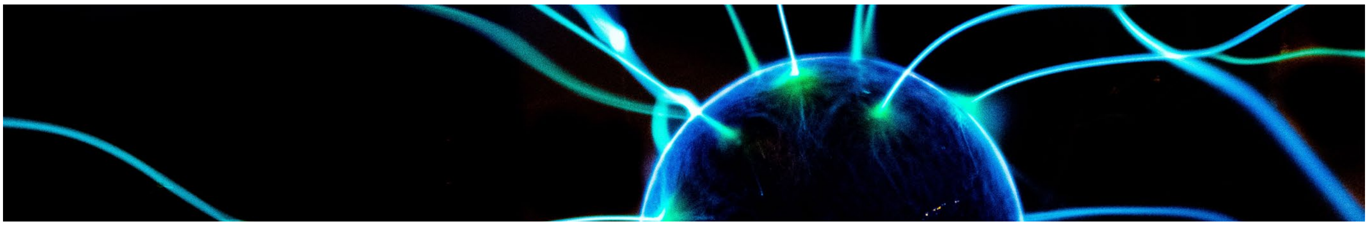
Emissions data for the AI industry is lacking, raising concerns about transparency. Framed in the context of net-zero pledges, this may be a concern. The World Economic Forum identifies AI as a "balancing act" between enormous potential and emissions.

Why we think it matters

It has emerged that the AI technology humans create is as biased as its creators, appearing to perpetuate gender and racial prejudice, among other biases, and to threaten democracy. Some legislators, including the EU, are developing legal frameworks to address the risks. Furthermore, the metallic components of AI systems are in high demand, and as this demand grows, environmental impacts and human rights concerns about supply chains accumulate, as do concerns about unchecked research and development.

Resources to help evaluate AI and digital technology-related risk

Source	Resource	Description
Business & Human Rights Resource Centre	Technology Company Dashboards	Presents company and financial information, human-rights abuse allegations, and collates benchmark ratings from a variety of sources.



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

Supply-chain emissions need more attention: CDP

Companies worldwide are failing to report the greenhouse gas emissions along their supply chains – even though such scope 3 emissions are found to be, on average, 11 times higher than companies' direct (scope 1) emissions. Disclosure-focused non-profit organization CDP has **assessed** the 18,000 company disclosures made through its global environmental disclosure system and found that only 41 percent of companies have reported any of their supply chain emissions, only 39 percent of companies have engaged their suppliers on climate-related issues, and even fewer have called out suppliers with regard to water-related issues or deforestation (23 percent). CDP states that companies need to understand that their environmental impact extends far beyond their direct operations, especially as imminent EU and US sustainability regulations will expect disclosure on supply-chain emissions. March 1, 2023

Read more (1) | Read more (2)

Risk factor

Deforestation targets "woefully behind," and deforestation policies noticeably absent: report

According to the latest ***Forest 500 Report*** compiled by non-profit organization Global Canopy, almost half of the 350 companies that rely mostly on commodities linked to deforestation are yet to set a single policy to limit their impact. The global deforestation performance report concludes that although pledges to achieve net-zero carbon emissions have grown five-fold in recent years, only half of those companies with deforestation policies in place have checked to see that they are actually being followed. None have achieved optimal human rights performance. The report comes as tough new laws in the EU and a growing swathe of international agreements demand due diligence for deforestation. February 15, 2023

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

Risk factor

Rapid increase in plastic pollution

French food corporation Danone, one of the ten biggest plastic producers in the world, is being **sued** for failing to reduce its production of plastic waste. The lawsuit comes as scientists are increasingly identifying environmental damage caused by plastic waste, such as **alarming** increases in plastic pollution in the ocean and a fog of **nanoplastics** lofting into the air. Despite growing recognition of the harm caused, plastics are being produced in ever-increasing quantities: the Minderoo Foundation has **reported** that single-use plastic production increased by 6 million tons between 2019 and 2021 – at a rate 15 times higher than the growth of recycled plastic production. By 2050, plastic production could **double** from current levels in G20 countries alone unless governments take steps to curb the rising tide. March 8, 2023

Read more (1) | Read more (2) | Read more (3)

Risk factor

Every major car manufacturer linked to banned supply chains in China, intensifying the risk of embargoes

Countless auto parts are now made by forced labor in Western China, according to the report entitled ***Driving Force – Automotive Supply Chains and Forced Labor in the Uyghur Region*** published by Sheffield Hallam University and NomoGaia. The report documents a recent wholesale, Chinese-government subsidized production shift into the Xinjiang Uyghur Autonomous Region, where more than one million Uyghur Muslims are currently incarcerated in detention programs linked to extreme abuse and forced labor. Due diligence challenges in the region have inspired new embargoes in the US (also proposed in the EU), which require proof that imports are not sourced from Xinjiang, or risk being impounded. January 4, 2023

Read more

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 — 2022 Q1	Q2	Q3	Q4	2023 Q1	FI exposure: % share of NGO actions criticizing FIs (SIGWATCH data)	ECOFACT risk rating	Noteworthy news
Oil & Gas	Pipelines	25	26	29	19	30	18%		Insurance broker's relationship with East African Crude Oil Pipeline subject of complaint to OECD. Read more
Oil & Gas	Oil sands	5	6	3	5	2	10%		First research to link significant earthquake to oil sands waste-water injection. Read more
Oil & Gas	Liquefied natural gas (LNG)	43	73	44	57	61	12%		LNG facilities found to be underreporting and miscalculating toxic emissions. Read more
Utilities	Gas-fired power	140	145	90	95	99	13%		Drought-affected US state looks to natural gas power plants to supplement hydropower deficits. Read more
Utilities	Hydropower	16	14	9	9	12	13%		Sedimentation behind hydro dams will reduce global holding capacity by a quarter by 2050. Read more
Utilities	Nuclear power	34	35	35	33	33	7%		Renewed interest in nuclear power rekindles questions about where to dispose of waste matter. 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 crisis worsens: Global risks report, 18th edition

The most severe global risks are outlined annually in the *Global Risks Report*. According to the **2023 report**, the cost of living will be a predominant theme for the next two years, while failure to take action over the climate is predicted to worsen over the next decade. In the meantime, widespread social unrest – tied to skyrocketing inflation and geopolitical confrontation – is set to continue, increasing the perilous tension between economic growth and climate-failure risk. With an ever-shrinking window for successful climate transition to a carbon-neutral world, "biodiversity loss and ecosystem collapse" are viewed among the most rapidly deteriorating global risks. This will be accompanied by a long-term failure to mitigate and adapt to climate change, natural resource crises, extreme weather conditions, and large-scale environmental damage incidents. January 11, 2023

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Climate lawsuits boiling over

Commitments to climate change targets will not prevent banks from facing a growing tide of climate-related litigation, **according** to financial credit rating agency Fitch Ratings. The agency predicts that such litigation will have limited financial impact, but that potential reputational damage may cause banks to withdraw from fossil fuel financing more rapidly. Lawsuits already underway include **action** against BNP Paribas in France taken by organizations demanding that the French courts force the bank to halt the financing of new fossil fuel projects. Banks are not the only bodies facing legal climate challenges: in the US, the state of Montana is facing a **constitutional lawsuit** alleging that its fossil fuel energy strategy is depleting protected natural systems, while similar legal challenges are in progress in **Canada**, **Australia**, and **Switzerland**, among others. February 23, 2023

Read more (1) → Read more (2) →

Sand crisis looming

The World Wildlife Fund (WWF) has **called** for global action to address the growing sand crisis. After water, sand is the world's second-most consumed resource, used in everything from concrete to road-base and electronics – yet only 5 percent of sand deposits are usable. The WWF has said that policies are urgently needed to establish an international tracking system for sand use, while individual countries need to understand their own resource-based planning with regard to sand, as well as how to manage sand use sustainably. Given that climate change will drive global migration and new construction, this is vital. The environmental impact of sand extraction also needs to be understood, and new construction technologies must be developed to reduce global pressure on sand resources. January 26, 2023

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.

→ Get transition-ready, or get booted: world's biggest investment fund urges portfolio company directors to improve their climate performance

Norway's sovereign wealth fund is threatening to vote against the boards of nearly 80 firms in which it holds investments over their lax climate and social targets. This would amount to a 30 percent increase in the number of board members vetoed last year due to the failure of companies to transition toward sustainable business models. Established in the 1990s with the purpose of investing surplus profits made by Norway's oil and gas reserves, the sovereign fund, which has reported a loss of USD 1.58 trillion for 2022, expects all large carbon emitters to set emissions targets now – and is determined to help push through to a sustainable climate transition. February 9, 2023

Read more (1) → Read more (2) →

→ New net-zero target-setting protocols for insurers and investors

UN-backed voluntary initiatives the Net-Zero Insurance Alliance (NZIA) and Net-Zero Asset Owner Alliance (NZAOA) have released and updated target-setting protocols designed to help their members rein in their carbon emissions. The NZIA's first Target-Setting Protocol provides guidance on science-based, intermediate targets for insurance and reinsurance underwriting portfolios. The NZAOA's third update of its Target-Setting Protocol for investors also incorporates the latest scientific information, expands target coverage across asset classes, and provides further details on target types. Neither protocol allows members to count carbon-removal technology as part of their emission reduction goals. The NZAOA has also released its updated position paper on oil and gas investment, in which it states that it expects its members to refrain from financing new oil and gas developments. March 1, 2023

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

→ 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	Q4 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	Q4 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
Indigenous rights	2	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: Deep-sea mining

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

→ The historic United Nations legally binding instrument on marine conservation and sustainable use, agreed in March 2023, has once again drawn attention to the colossal potential and imminent worries of harvesting metals and minerals from the deep ocean.

Extracting minerals between 200 and 6,500 meters below sea level is considered to be "deep-sea" mining. Many desirable metals (silver, gold, copper, manganese, nickel, cobalt, and zinc) are found around hydrothermal vents, which are known to be concentrated locations of deep-sea life.

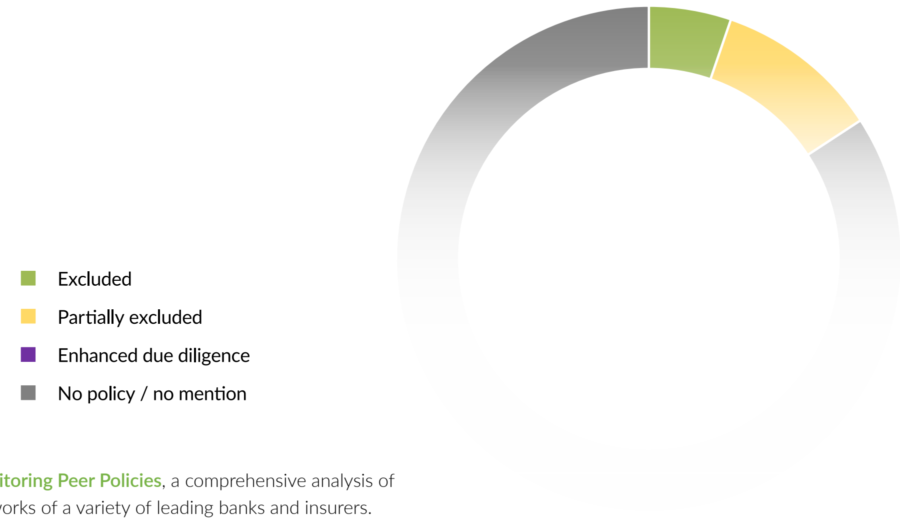
On the one hand, the low-carbon transition demands a continuous supply of materials to scale up alternative energy and storage systems; on the other hand, the deep ocean is a scarcely studied (probably fragile) ecosystem that influences the planet's weather, sequesters carbon, and supports fisheries and wildlife.

→ **Why we think it matters:** While the impacts of land-based mining have been researched for many years, deep-sea mining is a new frontier involving risks that are not yet understood. Some of the recognized risks are pollution, reduction or destruction of fish stocks, and irreversible damage to marine ecosystems.

It is physically difficult and expensive to evaluate the seabed for baseline studies, which also means that it is difficult to monitor and mitigate negative impacts.

Some financial institutions have recognized the risk potential, addressing the practice within their investment policies; however, as the chart below from ECOFACT's Monitoring Peer Policies service reveals, this is not (yet) a common practice. Nor has our research revealed policies or special considerations specifically for metals and minerals needed for the low-carbon transition, like the ones found in the depths of the ocean.

Do financial institutions have investment policies for deep-sea mining?*



*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.

→ Guidance on drafting sustainability-linked loans

The US's Loan Syndications and Trading Association (LSTA) has published **guidance** for banks and credit unions on drafting sustainability-linked loans (SLLs). SLLs are loans involving financial terms – such as reduced interest rates – that are explicitly connected to sustainability targets. Their proceeds should be invested in sustainable projects. The guidance document also provides advice on drafting "sleeping SLLs" – loans issued before clear key performance indicators and targets have been finalized. The LSTA states that sleeping SLLs should be avoided except under specific circumstances. While the draft guidance is designed for a US-style credit agreement, further guidance for other jurisdictions is expected. It is the first such industry guidance to have been released with this type of financing instrument in mind. February 21, 2023

Read more →

→ New nature-risk tools

Measuring impacts on nature and nature dependencies is vital if organizations are to understand their exposure to nature-related risks and take appropriate action. To help companies assess their biodiversity-related risk, the WWF has launched a new online tool, the **Biodiversity Risk Filter (BRF)**. The BRF contains information on species and ecosystems, protected areas, and major pressures on biodiversity – these include deforestation, habitat destruction, and pollution. The **Nature Risk Profile** published by the UN Environment Programme and S&P Global Sustainable1 also presents a double materiality methodology that enables businesses to analyze both their nature dependencies and their impact on nature. Finally, a **white paper** published by the Global Association of Risk Professionals examines biodiversity loss and explains why it matters in financial decision-making. January 17, 2023

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

→ TNFD released beta disclosure metrics

The Taskforce on Nature-related Financial Disclosure (TNFD) has released its fourth and final beta **framework** for disclosures. This final draft includes the long-awaited **disclosure metrics and targets section** on measuring biodiversity impacts. These metrics cover dependencies, impacts, risks, and opportunities, and include examples of metrics as well as links to tool providers and case studies. With this version, the TNFD framework has also adapted the "scopes" outlined by the Task Force on Climate-related Financial Disclosures (TCFD) for greenhouse gas emissions: whereas the TCFD addresses scope 1, 2, and 3 emissions, the TNFD discusses their effect on value chains across direct, upstream, downstream, and financed operations. Beta testing on the framework will continue until June 2023, with the comprehensive document expected to be issued in September 2023. March 28, 2023

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