ESG RISK QUARTERLY

ECOFACT's briefing for risk experts

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Editorial

Methane emissions from natural-gas systems have implications for ESG policies

In a recent interview, the executive director of the International Energy Agency (IEA), Fatih Birol, said that meeting net-zero targets required sufficient investment in natural gas to ensure a smooth transition – or in other words, natural gas is needed to avoid a steep decline in energy supply that would trigger drastic price spikes.

Unfortunately, natural gas consists almost entirely of **methane**, a powerful short-term greenhouse gas (GHG) that traps more heat in the atmosphere than carbon dioxide (CO2). In contrast to CO2, methane "only" contributes to climate change for a few decades, but it is the next few decades that are pivotal to meeting climate targets. Reducing methane emissions is seen as a **crucial lever** to achieve climate goals. The challenge at hand is deciding whether the climate impact of natural gas should disqualify it as a transitional fuel.

A recent **study** compared emissions throughout the life cycles of natural gas and coal. While coal systems produce significantly more local air pollution than natural-gas systems do, both systems are responsible for global warming impacts particularly through methane leakage along the value chain. The research suggests parity between life-cycle methane emissions of gas systems and coal infrastructure, depending on leakage rates. However, as little as 0.2 percent leakage may rule out natural gas as a suitable alternative to coal – aerial measurements of oil and gas production basins in the US identified leak rates of 0.6 to 66 percent!

Studies like this one are calling into question the wisdom of promoting natural gas as a **transitional fuel**. Evidence points to significant leakage along the entire value chain, from extraction through to distribution. Municipal **distribution networks** seem to be prone to massive leakage, too, and leakage from gas pipelines is **more than expected**.

If natural gas is reclassified as an unsuitable transitional fuel, there are broader consequences. It brings into question whether natural-gas investment should – as the IEA suggests – be viewed as a reasonable measure to mitigate spikes in energy prices. Considering the urgency of climate issues, it is possible that natural gas may become a no-go investment option.

For ESG risk teams, this dilemma has implications for their risk policies:

- **Transition risks of the natural-gas industry:** are business risks likely to increase further if the natural-gas industry fails to effectively reduce leakage within a reasonable time horizon? Note that governments have committed to **significant cuts in methane emissions** by 2030.
- **Measurement and disclosure:** how should systems' leakage play into institutions' calculation of their GHG emissions (scopes 1 to 3)?
- **Climate strategies and transition plans:** considering the environmental cost of methane, how should natural gas, even as a "transitional fuel," be addressed in a company's climate-related disclosures and strategies? This may be relevant for an organizations' supply chain or product portfolio.
- **Engagement:** what approach do risk teams take in their engagement with business partners, suppliers, or clients active in the natural-gas industry?
- **Policy documents:** financial institutions additionally need to figure out how to amend ESG risk policies for investments and lending, and – even more challenging – their adverse impact statements.

This natural-gas predicament is another example of how the quest for sustainability can lead to new challenges that lack simple solutions. Continuing, rigorous research will inform how we identify solutions that are truly viable. Science-based insights should not be glossed over.

Olivier Jaeggi

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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.

➔ TNFD recommendations featuring supporting guidelines for the finance sector now finalized

After two years of consultation, the Taskforce on Nature-related Financial Disclosures (TFND) has released its final **recommendations**, marking a significant step toward the integration of nature risk with financial, operational, and climate risks. Pilot tested by more than 200 financial institutions, the release includes guidance for 14 types of nature-related disclosures spanning governance, strategy, risk, impact management, and metrics/targets. The aim is to enhance the connection between nature, business, and capital, directing investments toward nature-positive outcomes. Key focus areas include nature's importance for business and finance as well as conceptual frameworks and metrics that can facilitate the integration of nature-related considerations into decision-making, risk management, and disclosures. September 19, 2023

Read more ➔

➔ ClientEarth urges Big Six accounting firms to improve climate reporting

ClientEarth, an environmental law charity, is calling on BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC to honor their commitment to clearly reflect climate risk in financial reporting and audit practices. In a letter to the Global Public Policy Committee (GPPC), a group of senior leaders of Big Six firms, ClientEarth states that the firms are failing to include climate risk fully in their audits. ClientEarth is urging the GPCC to clarify its position on climate risk accounting and to provide the promised leadership. July 27, 2023

Why we think it matters: As non-financial reporting moves from optional to mandated in more jurisdictions, the need for related assurance standards is becoming increasingly apparent. Already expected for financial reporting, assurance is an important step that furthers transparency and credibility.

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, as well as those of financial sector regulators, stock market authorities, and multilateral organizations. Please **contact us** for more information on regulatory trends.

Authority	What's on our radar	Date of next expected development
United Nations COP28 UAE	The 2023 United Nations Climate Change Conference of the Parties (COP28) will take place in Dubai. The event seeks to finalize the rules and guidelines for implementing the Paris Agreement and could trigger regulatory action related to emissions reporting and verification.	November 2023
Glasgow Financial Alliance for Net Zero (GFANZ) GFANZ	GFANZ is expected to launch the Net-Zero Data Public Utility for public consultation. It is intended to be an open, free, centralized data repository of companies' and financial institutions' climate transition-related data, commitments, and progress. **Read more** (for Policy Outlook subscribers) ➔	Q4 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/**

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Spotlight: climate change and nature loss are inextricably linked

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.

➔ Nature-related disclosure is having a "moment" – much like climate did when the Task Force on Climate-related Financial Disclosures first released its recommendations in 2017. However, the financial sector finds it difficult to address climate and biodiversity in tandem, given they are deeply intertwined. Tackling each in isolation (or prioritizing one over the other) will not deliver the results needed: a route to mutual acceleration is required. The Network for Greening the Financial System echoes this sentiment in its draft conceptual framework to guide central banks and financial supervisors in their actions.

The underlying concerns are not unfounded. A study published in *Science Advances* sounds the alarm about the health of our planet, noting that six of nine foundational processes that support life on Earth appear to have been transgressed. According to

New resources

Title	Source	Description
Taking Biodiversity into Account: Assessment of Dependencies on Ecosystem Services (PBAF Standard v2023)	Partnership for Biodiversity Accounting Financials (PBAF)	Supports financial institutions in their assessment of dependency-related risks and opportunities, the result of which can feed into the "Evaluate" step of the TNFD's LEAP approach (Locate-Evaluate-Assess-Prepare) and into Corporate Sustainability Reporting Directive and Global Reporting Initiative disclosures.
Underwriting our planet: how insurers can help address the crises in climate and biodiversity	World Wide Fund For Nature (WWF), Deloitte Switzerland	Guide for insurance companies to understand the impacts of their underwriting business on climate and biodiversity.

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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

Best practice

Measuring and making progress on mining risks

The impact and risks of the mining sector – such as emissions, land and water pollution, and human rights violations – are pressing issues for companies, stakeholders, and jurisdictions. Guidance from the International Council on Mining and Metals sets out how mining companies can calculate, disclose, and address their Scope 3 (indirect or value chain) greenhouse gas emissions. A new OECD handbook establishes a broader due diligence approach for mining companies to evaluate environmental and social risks, encompassing all process steps from extraction to processing. On the stakeholder side, the first net-zero standard from Climate Action 100+ details 100 metrics that investors and others can use to create a "scorecard" for mining and metals companies in order to track organizations' net-zero credibility and progress. September 7, 2023

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Risk factor

Brazilian financial institutions risk violating the Equator Principles

The Brazilian National Council for Human Rights, the government group overseeing the country's human rights policy, has published recommendations to BNDES, Banco do Brasil, Banco da Amazônia, Banco Genial, Itaú, John Deere Bank, and Banco Safra to suspend the financing of palm oil producer Brasil BioFuels (BBF). It recommends BBF financiers also investigate contract violations as there is "probable violation" of the Equator Principles. This comes amid escalating land conflict between Indigenous groups and BBF, including credible allegations of human rights abuses and environmental damages. BBF denies the accusations. The recommendations include directions for government departments from the national to local level, including the Ministry of Justice and Ministry of Foreign Affairs. August 14, 2023

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Risk factor

Chemical risks on the rise for the financial sector

According to non-government organization ChemSec, the financial sector is exposed to billions in "chemical risk" resulting from investments in companies that produce per- and polyfluoroalkyl substances (PFAS). These are persistent "forever chemicals" used in industrial and consumer products that include anything from cosmetics to fast food wrappers and firefighting foam. PFAS have been linked to human health problems, including cancer and hormonal disruption, and may be toxic to wildlife. As a result, PFAS producers worldwide are facing hundreds of lawsuits alleging health and environmental harm, and could be forced to bear massive environmental remediation costs. As an example of chemical-related risk to asset managers' portfolios, ChemSec points in particular to 3M's recent USD 10 billion payout over contaminated water supplies in the US. August 3, 2023

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Risk factor

The ocean floor is being removed at the rate of 1 million dump trucks per day

The world's first global Marine Sand Watch platform reveals that the marine dredging industry extracts 6 billion tons of sand from the oceans every year. Charting the exponential growth of this high-impact activity, the platform – developed by GRID-Geneva, an analytics subsidiary of the UN Environmental Programme (UNEP) – highlights increasingly unsustainable extraction rates. Using artificial intelligence and Automatic Identification System signals, it identifies and tracks the global activities of sand dredging vessels. Some countries, such as Indonesia and Thailand, have banned marine sand export, but international regulations vary. The UNEP's 2022 *Sand and Sustainability* report calls for better monitoring, international standards, and improved marine resource management. September 5, 2023

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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 Q3	Q4	2023 Q1	Q2	Q3	FI exposure: % share of NGO actions criticizing FIs (SIGWATCH data) / ECOFACT risk rating	Noteworthy news
Forestry	Logging and plantations	95	84	85	103	74	5%	Close to 60 percent of financial institutions that fund forest-risk commodities lack public policies on human rights, says Global Canopy. Read more
Mining	Coal mining	25	26	27	42	30	19%	Insurers snub coal mines with restricted or refused coverage; industry moving toward self-insurance to cover risks. Read more
Mining	Mining impact on Indigenous people	19	16	33	38	25	10%	Twenty-six of Canadian mining companies' projects in Latin America have been identified as violating free, prior, and informed consent. Read more
Agriculture	Palm oil	27	24	27	21	22	4%	Imported Scope 3 emissions from palm oil and other commodities pose material financial risks to investors and countries. Read more
Agriculture	Livestock agriculture	128	190	164	152	153	11%	Wide-scale drought kills crops and animals, triggering massive insurance pay-outs throughout North America. Read more
Agriculture	Deforestation by agriculture	46	60	35	54	34	27%	Brazil's beef exporters association notes that supply chain issues linked to illegal deforestation are tough to combat. 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.

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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-related insurance losses rising fast

Natural disasters **caused** USD 110 billion in damages in the first half of 2023, according to insurer Munich Re, including USD 42 billion in the US as a result of extreme weather alone. US government **data** confirms that extreme weather events are happening more frequently and causing more damage. Such disasters translate into substantial insurance claims, and as a result, US insurers have started employing a range of strategies to address climate risks. A major **survey** of climate risk disclosures in the industry finds that these strategies include refusing coverage for certain weather events (such as severe storms), or even completely exiting states such as hurricane-prone Florida. Others are seeking to address climate-related risks by supporting risk reduction programs or conducting climate risk assessments such as stress testing. September 11, 2023

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Car tires release toxic pollution

The air- and waterborne pollution released by car tires may be harmful to humans and wildlife. Globally, tires produce an estimated 6 million tons of particles – from macro- to micro- to nano-sized – each year. Tires contain heavy metals and more than 400 chemicals that have unknown effects on human health and the environment. One of these, 6PPD, used by all major tire manufacturers to prevent rubber from cracking and degrading, transforms into 6PPD-q in the environment; 6PPD-q was recently found to be acutely toxic to salmon and several other species of fish. The EU is negotiating a regulation – the "**Euro 7 standard**" – which restricts emissions from tires, among other things, and the California Environmental Protection Agency will require tire manufacturers to find an alternative to 6PPD by 2024. September 19, 2023

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Regulatory approach to "green growth" may be linked to income

Green growth is characterized by continued consumption while seeking to limit negative environmental impacts. In contrast, degrowth proponents argue that sustainability can be achieved only by reducing economic activity. A **study** published in the journal *Nature Sustainability* reveals that climate policy analysts from high-income countries are more likely than those from low-income countries to consider green growth as incompatible with planetary boundaries. Considering that there is extensive institutional support for green growth in high-income countries, this comes as a surprise. Green-growth skeptics are also more likely to favor direct regulation, such as quotas and bans, to achieve policy goals. The researchers note that growth positions appear to be influenced by income, and that this may be influencing systemic climate-policy decisions at national level. August 7, 2023

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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.

→ Funds still invest in weapons, but many banks do not

Many of the largest US mutual fund managers, including those managing retirement funds, have invested significantly in manufacturers of nuclear armaments and other "controversial" weapons, such as white phosphorus, landmines, and cluster bombs. NGO As You Sow reports that the 25 largest fund managers in the US have invested between 2.5 and 6 percent of their funds in arms manufacturers. Another NGO, Pax, notes that the financial sector can exert significant financial and reputational pressure on arms manufacturers, and many banks and financial institutions worldwide are increasingly opting to exclude investments in manufacturers of nuclear weapons. Pax finds that 109 financial institutions have chosen to restrict investments in nuclear weapons producers in 2023 – up from fewer than 40 in 2014. July 27, 2023

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→ Allianz unveils net-zero targets

Major insurer Allianz has announced an ambitious, three-pronged net-zero transition plan that includes downstream emissions. By cutting emissions in its own operations, throughout its property and casualty insurance businesses (including commercial insurance), and in its investments, the company aims to achieve net zero by 2050. To meet these targets, Allianz intends to be net zero in its internal operations by 2030, while increasing its revenues from insuring renewables and other low-carbon solutions (such as carbon capture and storage, battery technology, and electric transport) by 150 percent. Allianz will also invest EUR 20 billion directly in renewables. The downstream emission cuts across Allianz's insurance business will involve engaging with its clients to support their own decarbonization strategies, while the company maintains its targeted coal and oil and gas exclusion policies. September 7, 2023

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→ 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	Q3 2023	
	I	U
Agriculture	**1**	**1**
Agriculture commodities	2	0
Animal welfare	1	1
Palm oil	3	2
Forestry	3	2
Tobacco	4	3
Fisheries	2	1

Sector policy	Q3 2023	
	I	U
Utilities	**1**	**1**
Nuclear power	2	2
Coal-fired power	8	5
Hydropower	1	1
Human rights	**8**	**7**
Large-scale resettlement	1	1
Indigenous Peoples' rights	2	2

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

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

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Policy sector in focus: human rights – artificial intelligence

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

➔ Regulators are turning their attention to protecting consumers against the myriad material risks of artificial intelligence (AI). One recurring theme is the technology's potential to impact human rights. ECOFACT's recent blog post touches on this issue, as did the UN high commissioner for human rights in a July 2023 speech to the Human Rights Council. As more sectors employ the technology, a common sentiment is the need for limits. The EU's draft AI Act, if adopted, would set the world's first (risk-based) rules for AI use. The proposed rules categorize AI applications as posing "unacceptable," "high," "limited," or "minimal" risk, which would trigger prohibition, a conformity assessment, increased transparency, or a code of conduct, respectively.

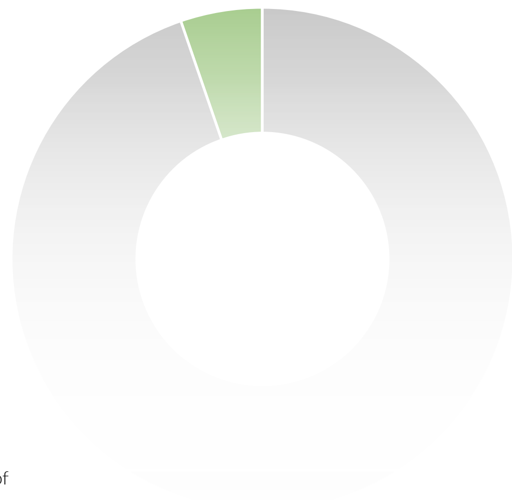
For financial institutions (FIs), this is a double-edged concern: FIs' own use of the technology poses risks related to their clients' right to privacy, freedom from discrimination, and fair access to services. An August 2023 International Monetary Fund

➔ Emerging good practices

In its July 2023 report, *AI and Human Rights in Financial Services*, BSR notes that companies in the financial sector lack internal processes to identify and mitigate risks related to their own use of the technology. However, good practices are developing. BSR highlights several FIs that state their ethical considerations with regard to AI, such as JPMorgan and Scotiabank. UNESCO published a structured assessment process in August 2023 that encourages those procuring AI to detect and critically examine the life-cycle risks of AI tools.

Why we think it matters

As the chart shows, the human rights-related risks of AI have yet

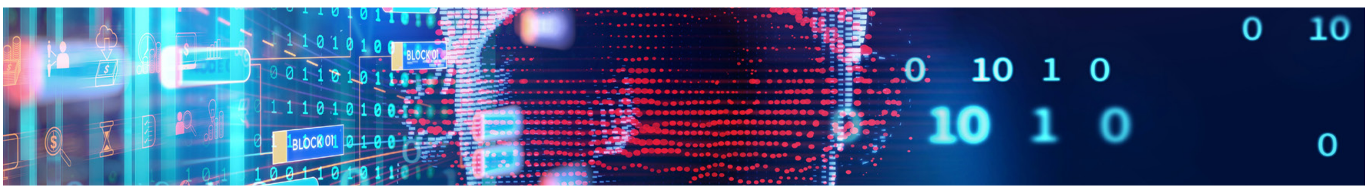


Proportion of financial institutions monitored by ECOFACT that mention AI-related human rights issues in their environmental and social risk policies or human rights statements

Document mentions human rights-related risks of AI

No mention of AI-related human rights risks

*Chart 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.



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New resources

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

➔ New climate reporting guide for financial institutions

To meet growing regulatory and investor demand for climate disclosures, Swiss Sustainable Finance and ECOFACT have collaborated on a comprehensive **guide** to climate reporting in alignment with the recommendations of the Task Force on Climate-related Related Disclosures (TCFD). While the guide addresses the Swiss financial sector, where mandatory reporting begins for many companies for the first time in 2024, it also provides critical information on reporting for financial institutions across all jurisdictions – including companies that are not yet legally required to make climate-related disclosures. The guide delivers an overview of relevant legal provisions, offers practical guidance, and cites real, best-practice examples of climate disclosures. It will assist organizations in effectively implementing their own climate reporting and provide a basis for strategic decision-making. August 23, 2023

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➔ White paper offers strategies for investing in the low-carbon transition

The Investor Leadership Network (ILN) has published a **white paper** to guide the financial sector in promoting real-world decarbonization. The white paper provides insight into innovative approaches for the investment community to assume a leadership role in the shift to a green economy, which will require an estimated USD 3 trillion of investment per year until 2050. The paper provides a summary of challenges, including trade-offs between short-term and long-term approaches, analysis of available strategies, acknowledgment of enablers and barriers, and eight case studies. In the paper, ILN members share a behind-the-scenes look at their experiences in promoting real-world decarbonization, including identifying opportunities, aligning portfolios, evaluating transition plans, and offering practical strategies to increase the flow of climate financing and accelerate the transition to a green economy. August 2023

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➔ Updated UNEP FI portfolio impact analysis tools

The United Nations Environment Programme Finance Initiative (UNEP FI) has released updated portfolio impact analysis tools designed to support banks in ensuring that their core strategy, lending, decision-making, and investments are aligned with the Sustainable Development Goals. Users enter portfolio data in the tool, which produces a set of impact profiles to identify significant impact areas and set priorities. Available within the **Context Module** or stand-alone, the **Needs Mapping** is updated annually and contains information on more than 100 countries across the 12 Impact Areas and 38 Impact Topics of the UNEP FI's Impact Radar. The new version provides updated data, adds new data gleaned from research and policy documents, fills gaps in impact topics, and provides a more thorough analysis of global-level needs. August 25, 2023

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