ESG RISK QUARTERLY

ECOFACT's briefing for risk experts

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ECO:FACT

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Editorial

Does nature need a business case?

Generic assertions like "bees are pollinators" won't lead to change. Don't get me wrong, I'm in no way ridiculing the role of bees or the role of **nature dependencies** in economic prosperity. But I continue to note a shortage of business cases that clearly justify broad nature conservation through a robust (quantitative) analysis of the consequences of harming nature. Have we made no progress since **Hans Carl von Carlowitz** explained why forests need to be managed sustainably — back in 1713?

A recent **article** uses case studies to highlight the financial cost of nature-related risk. While it does address "mismanaged interactions with nature," I was still hoping for an illustration of how adverse impacts on nature or ecosystem services in turn cause direct damage to companies. This is what a proper business case is: justification for a business decision based on its expected commercial benefit.

Here's a summary of those "mismanaged interactions": Avian influenza was unintentionally introduced into a poultry operation and authorities required the company to cull 159,000 turkeys. Tesla experienced construction delays because advocacy groups questioned whether a new "gigafactory" would cause local water stress. A group of companies faced legal liabilities and fines for polluting waterways. Others lost market value due to links to deforestation. And California's electric utility PG&E filed for bankruptcy after its infrastructure sparked out-of-control wildfires.

Aren't these classic cases of poor (risk) management, inadequate compliance, and irresponsible business conduct? Avian influenza poses a *global* epidemic risk, but certainly not a physical risk linked to the company's degradation of nature. Tesla's troubles were the consequence of protests, not because it actually depleted natural resources. And the other cases illustrate flawed business practices that affected valuation. The financial loss was indirectly linked to nature degradation but not caused by it.

The relationships between nature and companies are complex, and the business cases are not obvious. This is well explained by the **tragedy of the commons**, a concept frequently referenced by economists. It shows why humans tend to deplete natural resources: The individuals (over)consuming the resources pay no price. The financial consequences of nature loss usually result from the countless, small impacts of many actors. At the larger end of the scale, substantial adverse impacts caused by individual firms tend to have material consequences only when they trigger outrage or legal action.

This is why we need an alternative approach. Is it time to start valuing and conserving nature without first asking for a specific business case? We benefit from natural capital and ecosystem services in so many ways, and societies and the economy are better off when these services are safeguarded, as von Carlowitz explained so long ago.

Perhaps considering nature should be thought of as **responsible business conduct**, in which case environmental due diligence regulations may be a powerful tool. The above case examples demonstrate a need for better regulation and strict enforcement — and for companies and authorities to be more diligent when it comes to the environment.

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.

➔ Regulators take aim at AI

Artificial intelligence (AI) technologies may **worsen inequality** or even **destabilize** the financial sector. To prevent such effects, regulators are asking the industry to develop guardrails to guide AI's development and use. The UK-led **Bletchley Declaration**, for instance, calls for a "human-centric" approach to AI that focuses on transparency and accountability. In the US, President Biden has signed an **executive order** establishing transparency standards for the developers of certain AI systems and setting an agenda for possible regulation. The EU's proposed **AI Act** sets binding rules for AI developers governing transparency and ethics while limiting biometric uses (i.e. for law enforcement). It also proposes fines and measures to protect consumers' rights. However, some activists **claim** that the act, which has yet to become law, does not go far enough. December 12, 2023

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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
European Union (EU)	The EU Commission must decide whether it will advance the European supervisory authorities' proposed amendments to the regulatory technical standards of the Sustainable Finance Disclosure Regulation (SFDR). Proposed changes address the content and presentation of SFDR-related disclosures. Read more (for Policy Outlook subscribers) →	March 2024

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 Data Steering Committee (CDSC)	The Net-Zero Data Public Utility (NZDPU), an open, centralized repository for private-sector climate transition-related data, was launched as a proof of concept at COP28. The CDSC is accepting input that will contribute to further development of the tool. Read more (for Policy Outlook subscribers) →	March 1, 2024

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: water – an undervalued commodity

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.

➔ Everyone knows that water is essential for life. Both corporations and investors know that water is a vital input in nearly every supply chain imaginable. Water is both a (material) **risk and an asset**; however, this commodity is **mismanaged** and persistently **undervalued**. Such problems are exacerbated by the **misconception** that freshwater is an abundant resource.

The European Central Bank and European Systemic Risk Board **estimate** that 75 percent of euro-area bank loans are in economic sectors that rely heavily on at least one ecosystem service, suggesting dependencies with "profound impact" on the financial system. The manufacturing and agriculture sectors are notably

Why we think it matters:
Historically, it has been challenging to assign value to water. One **commentator** points out that it is regulators who set water prices rather than the market – promoting a purely return-on-investment approach that undervalues the resource. Supply and demand can also vary considerably

New resources

Resource	Author	Description
Financial Institutions are Valuing Water: How the financial sector is responding to the water crisis	CDP	Highlights actions of financial institutions that are early adopters of water disclosure as reported through the sector's first CDP questionnaire on water.
Valuing Water Finance Initiative Benchmark: Assessing Company Performance on Corporate Expectations Across Four Water-intensive Industries	Ceres	Evaluates the water stewardship efforts of 72 companies in food, beverage, apparel, and high-tech industries against the six **Corporate Expectations for Valuing Water**.

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

We are not on target to end deforestation by 2030

Three reports concur that deforestation remains too high to meet 2030 targets. Ceres has issued a report on the deforestation policies of 53 of the world's largest companies. Although most have a no-deforestation policy, only 18 policies are company-wide and only four cover the full supply chain. Rainforest Action Network's deforestation scorecard shows that most major global brands are failing on commitments to prevent deforestation and end violence against land defenders. Forest Declaration Assessment's report indicates that global deforestation was 4 percent higher in 2022 than in 2021, falling 21 percent short of annual targets required to end deforestation by 2030. However, some 50 countries are on track to end deforestation. The EU has proposed a satellite forest-monitoring system to collect and share EU-wide forest data. November 28, 2023

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Risk factor

Interplay between competition law and sustainability collaborations: survey

Linklaters' survey of more than 500 sustainability professionals across Europe and the US highlights concerns about potential risks pertaining to competition law that arise during sustainability-related collaborations. A comparison with the 2020 survey reveals a shifting regulatory landscape, with competition authorities in the UK and the EU (but not the US) now offering guidance on collaboration. While those aware of the guidance feel confident navigating this space, a notable number of respondents are unaware that the authorities have offered direction on this matter. November 3, 2023

Why we think it matters: International standards, such as the UN Guiding Principles on Business and Human Rights, invite companies to collaborate where reasonable. These standards can serve as the foundation of companies' collaboration as long as the approaches are not used to gain competitive advantage.

Read more

Risk factor

Food production depends heavily on oil, and a shift is urgently needed

About 15 percent of global greenhouse gas emissions – more than Russia's and the EU's emissions combined – are related to the production, transport, or storage of food, states a new briefing paper issued by the Global Alliance for the Future of Food and Dalberg Advisors. The paper is the first to analyze the use of fossil fuels from farm to table. Although renewables are replacing fossil fuels for transport and power, the fossil fuel industry is thought to be moving to lock in dependence on petrochemicals for plastic packaging, pesticides, and fertilizers. The latter and food-related plastics account for 40 percent of petrochemical products. The brief is accompanied by a discussion paper exploring the food-energy nexus, encouraging collaboration among policymakers, funders, and advocates, and highlighting opportunities for a positive shift toward renewable energy and regenerative farming. November 2, 2023

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Risk factor

Sustainability comes for fashion

The "raw materials manifesto" urges fashion companies to embrace sustainable raw materials in preparation for a wave of global sustainability legislation that will target the industry in coming years. However, analysis of 3,900 fashion companies has found that their complex supply chains work against sustainability, with environmental issues occurring in raw material processing, making it difficult for investors to apply pressure on companies. To do that, asset manager Robeco has announced the world's first fashion engagement strategy. Another report has found that over-production risks cancelling out any sustainability gains made by the industry, with the global textile market expected to grow by eight percent each year this decade. Finally, fashion companies in Asia have reportedly engaged in greenwashing by burning biomass and claiming that this polluting process is a fossil-free energy alternative. November 27, 2003

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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 Q4	2023 Q1	Q2	Q3	Q4	FI exposure: % share of NGO actions criticizing FIs (SIGWATCH data) / ECOFACT risk rating	Noteworthy news
Forestry	Logging and plantations	84	85	103	74	84	6%	Slave labor and deforestation, also by a soy producer, linked to green bonds issued by UBS and Santander. Read more
Mining	Coal mining	26	27	42	30	26	22%	A government that changed its coal mining policy was sued by five companies for billions in lost investment and potential revenue. Read more
Mining	Mining impact on Indigenous people	16	33	38	25	25	12%	Glencore and its financiers are accused of environmental damage and violating Indigenous groups' human rights in Peru and Columbia. Read more
Agriculture	Palm oil	24	27	21	22	26	7%	NGOs are shocked that it took the Roundtable on Sustainable Palm Oil (RSPO) five years to issue a decision regarding a complaint of RSPO rule violations. Read more
Agriculture	Livestock agriculture	190	164	152	153	156	11%	EUR 18.9 billion in investment was needed for the green transition of the agriculture sector, but EU banks denied financing to 50 percent of young farmers due to bank policy restrictions. Read more
Agriculture	Deforestation by agriculture	60	35	54	34	59	29%	First criminal complaint filed in France against banks for "laundering proceeds" from illegal deforestation in the Amazon. 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.

Greenwashing

With **USD 30.3 trillion** invested globally in sustainable assets, greenwashing is, **according** to the International Organization of Securities Commissions, a high risk to the reputation of global sustainable finance markets. An **investigation** into Europe's largest 20 banks has found that they actively promote their green finance credentials without providing transparency about their claims – a finding **reinforced** by the European Central Bank. Other **research** notes that while ambitious green claims are proliferating, too many commitments remain unverifiable, and a growing number of companies have been **linked** to misleading claims of sustainability. Morningstar Sustainalytics' **guide** on greenwashing risks points to vague definitions and unreliable data as major greenwashing pitfalls. Finally, the International Capital Market Association **recommends** that regulators fight greenwashing by focusing on more accurate data and applying existing fraud legislation. December 4, 2023

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Companies are investigating how their banks are adding to their carbon emissions

Companies are beginning to investigate and report the (scope 3) carbon emissions associated with their "financial supply chain," which encompasses their bank accounts, credit card service providers, and retirement funds. BankFWD, a non-profit organization advocating for financial sector decarbonization, estimates that of the money lent by the six largest US banks, about 24 percent goes to fossil fuel interests. Similarly, most retirement funds are heavily invested in fossil fuels. Tracking this category of carbon emissions is new for most companies, and those taking this step are still at the discovery stage. The next step will be to **engage** with banks on the sustainability of their actions. To get started, companies can examine their exposure, collect emissions data, and compare the emissions from their financial supply chain with their other emissions. October 25, 2023

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Climate change now the key risk

Environmental risks are now the most pressing concern for the insurance sector, **according** to AXA, which has mapped out the most pressing risks according to 3,500 global risk experts and 20,000 members of the public. Both groups named climate change as the biggest risk facing humanity, and both said that governments were "inadequately prepared." A **report** issued by the UN also warns of risk tipping points, which include biodiversity loss, extreme heat, melting glaciers, depletion of groundwater, and, notably, a lack of insurance. Each of these tipping points represents a major risk to the systems underlying global society. According to a new **survey**, extreme weather events have also surpassed cyber-attacks as the top operational risk – although 25 percent of businesses have said they have no extreme weather mitigation plans in place. November 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.

Banks to transition finance

A coalition of NGOs has called on the financial sector and governments to rapidly intensify the scale of transition finance to fight the climate crisis. The letter calls on banks to develop transition finance-friendly policies and products that match the scale of the climate crisis. Governments should create an enabling policy environment that helps to de-risk transition finance, while borrowers should actively demand transition finance. Existing transition finance metrics may fail to provide a full picture of what banks are doing in this sphere. Better measurements could include the volume of transition financing, committed decarbonization measures, or physical indicators of decarbonization and sectoral metrics. Banks can begin by tracking clients' transition plans while building internal policies and setting targets for transition financing. December 2023

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G-SIBs overplay their net-zero commitments

The European Central Bank's research paper reviews net-zero commitments issued by global, systemically important banks (G-SIBs), noting increased detailed disclosures and participation in net-zero alliances. The paper also highlights certain areas for improvement in climate-related risk disclosures among G-SIBs in 2022. These include disparities in setting targets, lack of clarity regarding exposure to carbon-intensive sectors, ambiguous "green financing" goals, and reliance on carbon offsets by some institutions. These issues could lead to litigation and reputational risks, along with accusations of greenwashing. The paper recommends that banks adopt a common minimum framework similar to the EU's Corporate Sustainability Reporting Directive. It also advocates integrating a transition planning framework into their risk management processes in order better to understand the impact of strategic actions on achieving net-zero goals and to improve sustainability disclosures. November 28, 2023

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	Q4 2023	
	I	U
Agriculture	1	1
Agriculture commodities	2	0
Animal welfare	1	1
Palm oil	3	2
Forestry	3	2
Tobacco	5	3
Fisheries	2	1

Sector policy	Q4 2023	
	I	U
Utilities	1	1
Nuclear power	2	2
Coal-fired power	9	5
Hydropower	1	1
Human rights	8	7
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: coal and the "just transition"

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

➔ The Global Energy Monitor **predicts** that up to one million jobs in the coal mining industry will no longer exist by 2050. This estimate only considers job losses at coal mines reaching the end of their life. Job losses linked to international climate commitments and resulting from coal phaseout policies could increase this figure. Another **report** asserts that 240 coal-fired power plants must be retired every year by 2030 if emission-reduction targets are to be met. This raises critical questions about the role of finance in ensuring that the net-zero transition leaves **no one behind** (i.e. the "**just transition**").

The **COP28 decision** addresses this, calling for the transition away from fossil fuels in energy systems to be "just, orderly, and

Some financial institutions are **exploring** ways to finance the commodity in a manner that aligns with their net-zero goals, such as this **guide** to financing the managed phaseout of coal-fired power plants in the Asia Pacific region. (However, there is considerable **criticism** of the continued financing of coal expansion.) Other **best practices** that have been suggested include not investing in new, unabated coal projects and requiring investees to have a coal phaseout plan. Institutions are also starting to assess clients'

What are financial institutions noting in their coal-related investment policies?

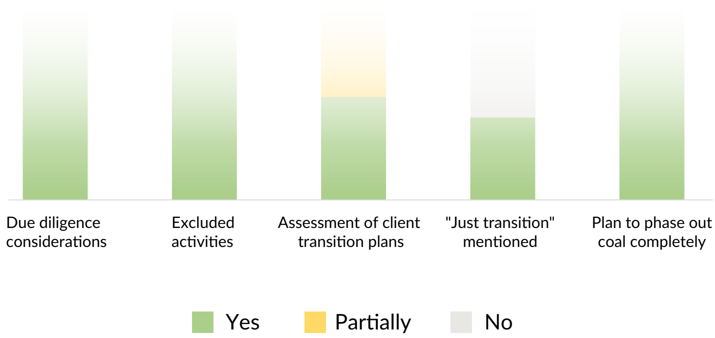

*Chart based on data from ECOFACT's **Monitoring Peer Policies**, a comprehensive analysis of environmental and social policies and frameworks of a variety of leading banks and insurers.

New resources

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

➔ New guide will help boards embed ESG into company strategy

Accountancy Europe, ecoDa, and ECIIA have issued a **document** to assist boards in embedding ESG factors into their strategy and business models and practices. As stakeholders increasingly demand sustainability and policymakers introduce legislation, companies must improve their sustainability performance and disclosure. The document outlines practical questions for companies to ask themselves in three key areas: business model transformation; aligning governance with sustainability objectives; and sustainability information, reporting, and assurance. This "toolkit" will help boards to plan their transition to sustainability by limiting risks, maximizing opportunities, and avoiding greenwashing. The document incorporates input from company directors, internal auditors, and accountants. It emphasizes that sustainability is not only an obligation, but a strategic imperative. November 2, 2023

Read more ➔

➔ A new resource to assess corporate political conduct

The global push for corporate responsibility often excludes a company's "political footprint." This refers to a company's influence on public policy through lobbying, political spending, and other efforts. While existing ESG ratings, sustainability reporting standards, and voluntary frameworks encourage companies to disclose lobbying-related information, they fall short in capturing the entirety of corporate political activities. This creates a significant blind spot for investors and regulators. The **Good Lobby Tracker**, launched by Good Lobby, a non-profit organization, aims to address this gap by systematically assessing major corporate political responsibility reporting initiatives, enhancing transparency, accountability, and usefulness. This tool assists various stakeholders, including business practitioners, investors, and policymakers, in evaluating and understanding the political conduct of companies, ultimately contributing to a more visible, well-governed, and socially impactful corporate landscape. October 5, 2023

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➔ New tools for nature

New initiatives that focus on finance for nature are emerging. The **Nature Target Setting Framework** (beta version) published by the Finance for Biodiversity Foundation (FfB) helps asset owners and managers set and make progress on targets for nature. The FfB also offers guidance for financial institutions on the nexus of nature and climate. The Principles for Responsible Banking's **Target-Setting Guidance** is a systematic approach designed to enable banks to set nature targets, while the **Nature Strategy Handbook** presents a process for all businesses seeking to develop a credible nature strategy. The open-access **Integrated Biodiversity Assessment Tool** available on the Taskforce on Nature-related Financial Disclosures website provides a scientific assessment of critical biodiversity areas worldwide. Finally, the UN-backed **Finance Resource Database for Biodiversity** matches nature-related projects with public and private funders. December 8, 2023

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