ESG regulatory news

April 2020

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Executive summary

- The regulatory focus on environmental, social and governance (ESG) issues as well as sustainable investing continues to gather speed. While Europe still leads the way, global regulators – such as the International Association of Insurance Supervisors (IAIS) and the International Organisation of Pension Supervisors (IOPS) – are increasingly focusing on these issues.

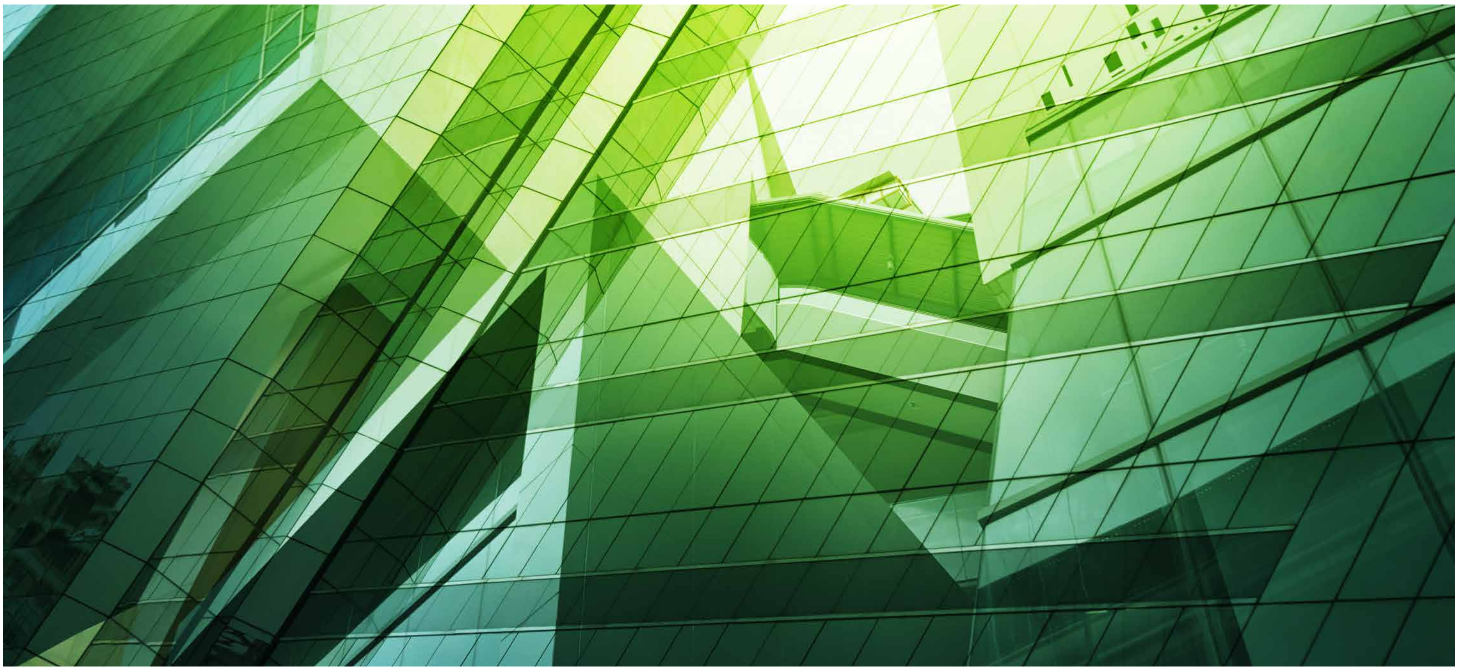
- There is a growing convergence around regulatory expectations in this regard, focusing on three key areas:
  - Governance and strategy in relation to ESG risks
  - ESG integration by financial firms, in both their investment and risk processes
  - Reporting of climate risks, with a groundswell of support for the Task Force on Climate-related Financial Disclosures (TCFD) framework
  - Scenario analysis to assess the possible impact of ESG risks, particularly climate risks

- While ESG integration is the baseline, there are increasing efforts to align portfolios with the Paris Agreement. To assist in this process, the European Union reached a landmark deal on the creation of a so-called taxonomy for sustainable investments. This will allow investors to assess – based on scientific criteria – the extent to which the companies they invest in are aligned with the Paris Agreement.

- Reporting on ESG issues is increasingly a focus area. In Europe, the new sustainability-related disclosures regulation, which requires financial market participants to disclose their approach to ESG integration and enhance their disclosures for sustainable products, was adopted in December and will enter into effect on 10 March 2021. At a global level, the IAIS has signalled that prudential regulators are considering the introduction of mandatory reporting by insurers according to the TCFD framework.

- Developing scenario analysis is a priority for regulators, with the Bank of England announcing it will conduct the first in-depth climate stress test for UK banks and insurers. The European Insurance and Occupational Pensions Authority (EIOPA) has also started including ESG issues in their stress tests for insurers and pension schemes. The Network for Greening the Financial System (NGFS) is expected to publish its work on scenario analysis in April 2020.

- Enhancing standards in the retail market for sustainable products is another strand of work that is gathering pace in Europe. This includes the EU's development of an ecolabel for green funds and the involvement of national regulators – such as France's Autorité des Marchés Financiers (AMF) – in helping set minimum standards for funds marketed as sustainable. We expect this topic to become increasingly important as the EU moves towards implementing a new regime for sustainable product disclosures, while introducing changes to distribution rules so that a client's ESG preferences must be given consideration.



Europe makes a splash

On 11 December 2019, the European Commission launched its European Green Deal strategy, which aims to make Europe climate-neutral by 2050 through 50 initiatives. While the focus of the strategy is on the real economy, it includes a chapter on financial services. As part of the new Sustainable Finance Strategy, the EU will propose a new label for green funds (see below) and an EU Green Bond label. The EU will also explore whether prudential rules for banks and insurers should be reviewed to incentivise investment in green activities. A consultation on the new Strategy was launched in early April and the final Strategy is expected in Q3 but the timeline, along with many other measures outlined below, could be impacted by disruption due to the coronavirus pandemic.

Defining "green" for European financial products, and the economy

All of these initiatives will rely on the newly agreed taxonomy, which will create a framework for assessing the environmental sustainability of economic activities. The framework will focus on six environmental areas: climate change mitigation, climate change adaptation, water and marine resources, waste management and recycling, pollution prevention and control, and biodiversity. For each objective, criteria will be developed in order to establish which economic activities can be considered environmentally sustainable. The draft rules for climate change mitigation and climate change adaptation are already in development and are due to be finalised by the end of 2020. The rules for the other four environmental objectives are due to be finalised by the end of 2021. While aligning portfolios with the new framework will remain voluntary, providers marketing products as environmentally sustainable will be required to disclose the extent to which they finance activities that meet the taxonomy criteria. Any product that is not marketed as environmentally sustainable will need to include a disclaimer stating that the product does not take into consideration the taxonomy. Importantly, companies that fall under the Non-Financial Reporting Directive (NFRD) – which covers the 6,000 largest companies in Europe – will be required to disclose the percentage of turnover, capital expenditure and/or operating expenditure that meets the taxonomy criteria. A full review of the NFRD was launched at the end of February to explore how to improve non-financial reporting and whether the scope of companies subject to the NFRD should be expanded.

Embedding sustainability across the financial services regulatory framework

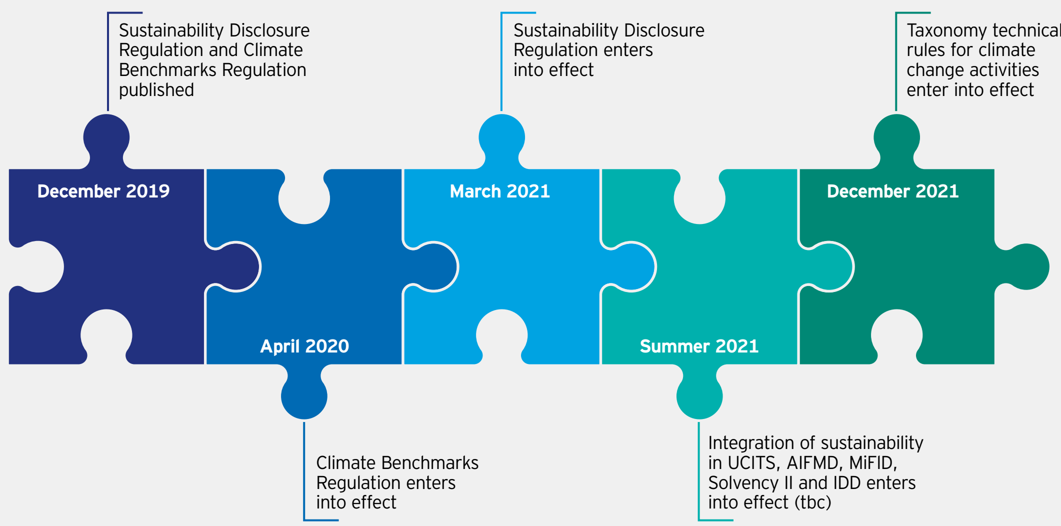
Other regulatory initiatives, including the regulations on sustainability disclosures and climate benchmarks, were finally published in the EU's Official Journal in December and will take effect on 10 March 2021 and 30 April 2020, respectively. Implementation timelines will be particularly challenging as the technical rules for these regimes are yet to be agreed and will probably still be in draft form when the rules officially take effect (see figure 1). Changes to UCITS, AIFMD, Solvency and IDD, which were also expected to be adopted at the end of 2019, have been delayed and have yet to be adopted at the time of writing and could have to wait some months before seeing the light of day as the Commission focuses its attention on the fall-out from the coronavirus pandemic.

Banking on sustainability as the EBA sets out its strategy

In addition, sectoral regulators are in the process of iterating their own plans for embedding sustainability into their work. The European Banking Authority (EBA) published its own action plan after being vested with new powers in relation to sustainability (see figure 2). The EBA will break down the work into four building blocks: strategy and risk management, key metrics and disclosure, stress testing and scenario analysis, and prudential treatment. The EBA expects significant work to be undertaken on the first three blocks over the course of 2020 and in the early part of 2021. However, the work on prudential treatment will take significantly longer, with the report due only in 2025. In anticipation of the new rules, the EBA encourages firms to proactively incorporate ESG considerations into their business strategy and risk management; to continue to work on ESG disclosures based on the NFRD, including prioritising the identification of some simple metrics that provide transparency on how climate change risks are embedded in their business strategy; and to develop climate-related scenarios and explorative tools.

The EBA has also published a guide on market practices in sustainable finance. The report explores

Figure 1
The Sustainable Finance Jigsaw Puzzle



Source: Invesco. For illustrative purposes only.

Figure 2
EBA Action Plan on Sustainable Finance

1	**Strategy & risk management (CRD5)** Discussion paper in Q1-Q3 2020; final report due by 28 July 2021
2	**Stress testing and scenario analysis** EBA to develop climate stress tests for banks, starting with sensitivity analysis in H2 2020
3	**Key metrics and disclosures (CRR)** Technical standards on ESG disclosures due by 2021
4	**Prudential treatment** Report under CRD5 due by June 2025

Source: EBA, Invesco. For illustrative purposes only.

how European banks define ESG, as well as their approaches to strategy, governance, disclosure and green products.

ESMA's strategy for securities markets in Europe focuses on transparency
ESMA has also published its own Sustainable Finance Strategy, which centres on the delivery of the new rules under the Sustainability Disclosures Regulation, as well as undertaking research and analysis on financial risks from climate risk and undertaking scenario analysis in different market segments (see figure 3).

Beyond Brussels, national financial supervisors are also issuing local rules and guidance
And national regulators are also moving ahead with their own guidance, even though the EU rules are yet to be finalised. The German supervisor, BaFin, has published a Guidance Notice on Dealing with Sustainability Risks, addressing all financial market participants. The notice sets out best practice for firms in the area of strategy and governance, organisational requirements, risk management and stress testing. The Sustainable Finance Committee of the German Ministry of Finance has also published its interim repot setting our proposals to make Germany a hub for sustainable finance, with a particular focus on corporate reporting and scenario analysis.

Global insurance and pension regulators are getting in on the act
Global regulatory bodies are increasingly turning their attention to ESG issues and we see a growing convergence around what best practice looks like across the industry.

The IOPS, which sets standards for pension regulations globally, published supervisory guidelines on the integration of ESG factors in the investment and risk management of pension funds. The guidelines build on existing best practices such as IORP II, TCFD and NGFS.

Figure 3
ESMA Sustainable Finance Strategy - timeline

Timeline	H1 2019	H2 2019	H1 2020	H2 2020	2021
Single rulebook	Delivery of advice on UCITS, AIFMD & MiFID	Delivery of advice on short-termism	Amendment of ESMA's TS procedures to include ESG factors	Expected delivery of first set of Disclosures RTS	Expected delivery of second set of Disclosures RTS
Supervisory convergence		Mapping of national supervisory practices	ESG training incorporated in ESMA training programme		ESG factors mainstreamed into ESMA's topical training courses
Direct supervision		Delivery of advice on ESG factors in CRAs	Supervision of CRA ESG transparency		
Risk assessment			Dedicated Sustainable Finance TRV chapter	Mapping of national indicators	
Outreach				Establish CWG	

Source: ESMA, Invesco. For illustrative purposes only.

While voluntary in nature, the guidelines are intended to help national pension regulators to enhance their approach on this issue. The report includes 10 high-level, principles-based guidelines covering ESG integration in their investment and risk management processes; disclosure both to the regulator and to beneficiaries; and the use of scenario analysis. The guidelines explicitly call for supervisors to avoid an overly prescriptive approach, focusing instead on policy implementation as well as the proper documentation, monitoring and measurement of risks that the firms identify as material.

The report makes clear that a line should be drawn between financial and non-financial factors. While ESG factors can exhibit characteristics of both, the guidelines are specifically focused on the financial dimension of ESG factors and are not intended to induce pensions funds to invest in ESG investments. In fact, the guidelines specifically mention that pension funds should consider ESG factors without prejudicing the objective of achieving an appropriate risk-return profile on purely financial grounds. In addition, where a pension fund wishes to take into account non-financial factors that could entail sacrificing some return, this should be done with the informed consent of beneficiaries, according to the guidelines.

The IAIS has also published its report on climate risks and TCFD for the insurance sector. Based on a survey of 18 insurance regulators, the IAIS found that all of them see climate as presenting "reasonable, foreseeable and relevant material risks" that should therefore be considered in existing enterprise risk-management requirements. The report notes that risk quantification techniques and models are most advanced for physical risks but are still in an early stage for transition and liability risks. Stress testing and scenario analysis are seen as useful tools for improving the understanding of climate risk exposure, even though they involve limitations and assumptions. However, beyond the numerical results, stress testing and scenario analysis can be particularly valuable in facilitating discussion on risk strategy within a company.

With respect to disclosures, the IAIS report notes that while climate risk awareness is high among insurers (73%), the transition from awareness to action has been limited, with only 15-20% of firms taking (or planning to take) steps towards implementing the TCFD recommendations. Those that have done so tend to be larger firms in developed markets and have primarily focused on the more qualitative elements of the TCFD, such as governance and strategy. The IAIS encourages its members to support the adoption of the TCFD recommendations, either on a voluntary or mandatory basis, while providing best practice for firms. The IAIS will develop an application paper on climate risks to offer additional supporting materials to firms and supervisors later in 2020.

Stress testing and scenario analysis for banks, insurers and pension funds are the new game in town

As noted above, stress testing and scenario analysis are a key focus of regulators as a means to assess and measure ESG risks, particularly those relating to climate.

The Bank of England announced its intention to undertake a stress test for UK banks and insurers as part of its biennial stress test, however this has now been postponed in light of the evolving pandemic. The central bank also issued a discussion paper on the proposed methodology. The aim of the stress test is to monitor the UK financial system's resilience to physical and transition risks associated with different climate pathways, building on the exploratory stress test for insurers that took place last year. The precise scenarios and specifications will be based on

Figure 4
Proposed criteria for European eco-label

Green activities	Exclusions	Social and governance	Engagement	Disclosure
- Minimum threshold for investment in Taxonomy-aligned activities according to product type and asset class - For example, equity funds must have 60% of portfolio invested in companies with Taxonomy-aligned turnover (<20% in companies with 50%+ Taxonomy revenues, >40% in companies with 20-49% Taxonomy revenues)	- Extensive list of exclusions in agriculture, forestry, energy sector, waste management, manufacturing and transport - For sovereigns, only sovereigns that are signatories to the Paris Accord and other key international treaties are eligible	- Portfolio holdings must comply with key international treaties on social issues such as UN Global Compact and ILO - Exclusions for tabacco, pornography, weapons	- For investment funds only, fund managers must have documented engagement policy	- Funds must disclose annually how they have performed aganist the above criteria - For deposit accounts, banks must provide an itemised list of projects and activities for which loans have been approved

Investment funds | **Investment-based insurance** | **Deposit and savings**

Source: European Commission Joint Research Centre, Invesco. For illustrative purposes only.

the NGFS scenarios due to be published in April 2020. Participating firms will be tasked with modelling the impact on corporate, household and government exposures at a granular level in order to quantify the impact on their assets and liabilities, as well as their overall portfolio alignment with the Paris Agreement's temperature goals. The initial intention was to gather evidence from firms in the second half of 2020 and publish findings in mid-2021. However, due to the cororavirus, the Bank of England has indicated that it will take stock of the evolving situation and announce a way forward in due course.

EIOPA published the findings of its latest biennial pension fund stress tests, which for the first time included a request to pension funds to include information regarding their holdings in high-emitting sectors. The report found that pension funds had considerable exposure to high-emitting sectors. In particular, firms based in Slovenia and Slovakia have significant holdings in the energy sector. The high-level analysis only looked at exposure to broad sectors (energy, manufacturing, agriculture and transportation) and did not differentiate between low-carbon and high-carbon companies within each sector.

In terms of firms' current approach to ESG, the survey found that only 19% of pension funds have assessed or analysed the actual effect of ESG factors on the risks and rewards of investments, with companies in Austria, Spain, the Netherlands and Sweden most advanced in this regard. Most firms adhere to principles on responsible investment and have exclusion policies in place, with voting and engagement also being undertaken by a significant number of companies. Impact investing and best-in-class investing were less prevalent, with only 21% and 31% of firms respectively including these approaches in their investment strategy. The report noted that the assessment took place prior to the entry into force of IORP II, which includes new requirements on ESG integration. As a result, there are likely to have been significant changes in the intervening period.

Promoting retail investment in sustainable products
As sustainable investment products grow, there is an increasing focus on whether such products "do what they say on the tin". There has been a proliferation of approaches and labels that fall under the ESG banner, all with different requirements that can cause confusion for investors and complexity for product providers.

Part of the answer put forward by the EU is to create a European label for green products. In its second draft proposal issued in January 2020, the European Commission's Joint Research Centre said the so-called ecolabel should be available to funds, investment-based insurance products and bank deposit accounts, with the criteria required to gain the label varying by product and asset class (see figure 4).

In France, the AMF has published new rules for the marketing and disclosure of ESG funds. The final rules require that only funds whose ESG investment criteria were deemed "restrictive and significant" would be eligible to be marketed as ESG funds. This would primarily be defined would be defined as products where the ESG criteria result in the exclusion of at least 20% of the investment universe, following the French SRI label but other approaches would also be allowed on a case-by-case basis.. In addition, ESG funds would need to demonstrate that a minimum of 90% of the portfolio has an ESG rating. ESG funds would also have enhanced disclosure rules. While only applicable to funds marketed in France, we believe these show that regulators are looking to go beyond pure disclosure and towards greater convergence on what minimum standards for ESG products should cover. With the European Securities and Markets Authority due to consult on guidance in implementing the new suitability and target market regime for ESG products this year, this issue could well find its way into EU rules via this route due to pressure from product distributors and regulators.