



Delivering sustainable finance

The new reality publication series



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New publication series

The EMA FS Risk and Regulatory Insight Centre (RRIC) is pleased to publish the third paper in its new thought leadership series ***Financial Services: regulating the new reality***.

As the focus of government and businesses moves from initial response to the COVID-19 pandemic, through resilience concerns, to recovery and the new reality, financial services regulators are also expected to move into a new phase of adjustment and support.

This paper looks at how the financial services industry is being called upon to deliver sustainable finance and to take account of ESG risks. Over the coming months, look out for further articles and papers in which we will build on the themes identified in the first overview paper.

Financial services: regulating the new reality

Remote governance and controls paper

Other relevant publications

Impact of ESG disclosure: Embracing the future

The numbers that are changing the world

Contents

Executive summary	04
01. The search for consistency	07
02. ESG-related corporate reporting	08
03. Disclosures and benchmarks	12
04. Incorporating ESG into risk frameworks	15
05. Product governance and distribution	18





Executive summary

Given governments' climate change commitments, sustainable finance was already on regulatory agendas. The COVID-19 pandemic has highlighted that business sectors are deeply interconnected across borders, that societies of all types and wealth levels are vulnerable, and that the environment is under increasing strain. Labour inequality and human rights are to the fore. Around the globe, investor and customer demand remains a key driver of change, but the pursuit of sustainable finance is now driving regulatory priorities. The regulatory initiative that started in the EU is spreading, and corporate reporting requirements and financial services regulation are aligning.

While firms move through the recovery phase, they need also to look to the new reality, in which delivering sustainable finance will be an imperative. Whatever their business activities, client base or geographical coverage, financial services firms need to act, and need to do so now.

A global backdrop

The IMF Global Financial Stability Report of April 2020¹ said *"Disasters as a result of climate change are projected to be more frequent and more severe, which could threaten financial stability."* The report finds the impact of large physical disasters on equity markets generally to have been modest over the past 50 years, and that investors do not pay enough attention to these risks. The report argues that better disclosures and stress testing for financial firms can help preserve financial stability and should complement policy measures to mitigate and adapt to climate change.

In June 2020,² Christine Lagarde, President of the ECB spoke of the path out of uncertainty and said, *"I therefore encourage you, as policymakers, not to let this crisis go to waste."*

My institution, the ECB, will play its part within its mandate. But it is for you to prove to citizens that our societies will emerge from this transformation stronger and greener. If we are collectively successful, uncertainty will start to turn into confidence, and then a real recovery can begin."

Without consistent definitions and disclosures, it is difficult for firms to determine the data required to measure ESG (environment, social, governance) risks and exposures or to satisfy reporting and disclosure requirements. Accountancy bodies and standard setters have joined forces to strive for consistency in financial and non-financial reporting. Corporates are responding to asset owners and activist investors by improving their ESG disclosures and credentials.

These reporting standards and investor demands apply not only to the corporates to which financial services firms (or the portfolios or products they manage) are exposed, but also to the financial services firms themselves.

Individual jurisdictions are taking different approaches to sustainable finance regulation. Some governments have developed over-arching strategies. Some financial regulators have adopted specific requirements, while others have, to date, tended to leave it to market forces. Global regulatory bodies have raised concerns about the diverse range of sustainability standards and are calling for consistency. Whatever the chosen approach, the volume of activity adds to the pressure on financial services firms to respond.

¹ <https://www.imf.org/en/Publications/GFSR/Issues/2020/04/14/global-financial-stability-report-april-2020#Chapter5>

² <https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200613~890270bad1.en.html>

EU regulation is far-reaching and expanding

EU financial services regulation is leading the way and will have far-reaching effects. The EU Taxonomy Regulation has written into law a definition of “environmentally sustainable” and applies to both corporate reporting and financial services regulation. Further details are being drafted on the six broad categories in the Regulation and on green versus brown economic activities.

Institutional investors (including insurance companies and pension funds), asset managers and managers of collective investment funds or personal pension products are all in scope of the new ESG disclosure requirements. The requirements will have significant ramifications for all types of companies and enterprises in which the firms invest, within the EU and beyond, including other financial services firms or their products.

Financial advisers and other distributors of financial products are required to incorporate ESG factors into their “suitability” assessments.

Supervisors are requiring banks and insurers to pay greater attention to climate-related risks within their risk frameworks and in their stress testing exercises. Regulation is expected in this area too. The European Commission’s renewed Sustainable Finance Strategy includes proposals that climate and environmental risks should be fully managed and integrated into financial institutions, and that social risks should be considered, where relevant. Two new categories of low-carbon benchmarks have been created, there are ESG disclosures for all benchmarks, and guidelines on disclosures by EU credit rating agencies have been enhanced.

Detailed rules are being drafted to underpin the regulations that have already been adopted and more legislation is on the way, including a Green Bond Standard and an EU Ecolabel for investment products.

The Commission’s five-year Gender Equality Strategy³ includes a proposal for binding measures on improving the gender balance on corporate boards.

A strategic approach

Some deadlines may seem far off and the underlying details still uncertain, but the necessary data collection and testing could alone take many months, so it is essential that firms start now, if they have not done so already. The temptation may be to focus on specific corporate reporting or disclosure requirements in order to meet the most pressing deadlines. This approach may tick certain boxes but risks missing the fundamentals of stakeholder demand and regulatory expectations.

Firms that place implementation of and compliance with regulatory requirements within the context of a defined ESG company strategy and governance structure will likely fare better in the medium to longer term.

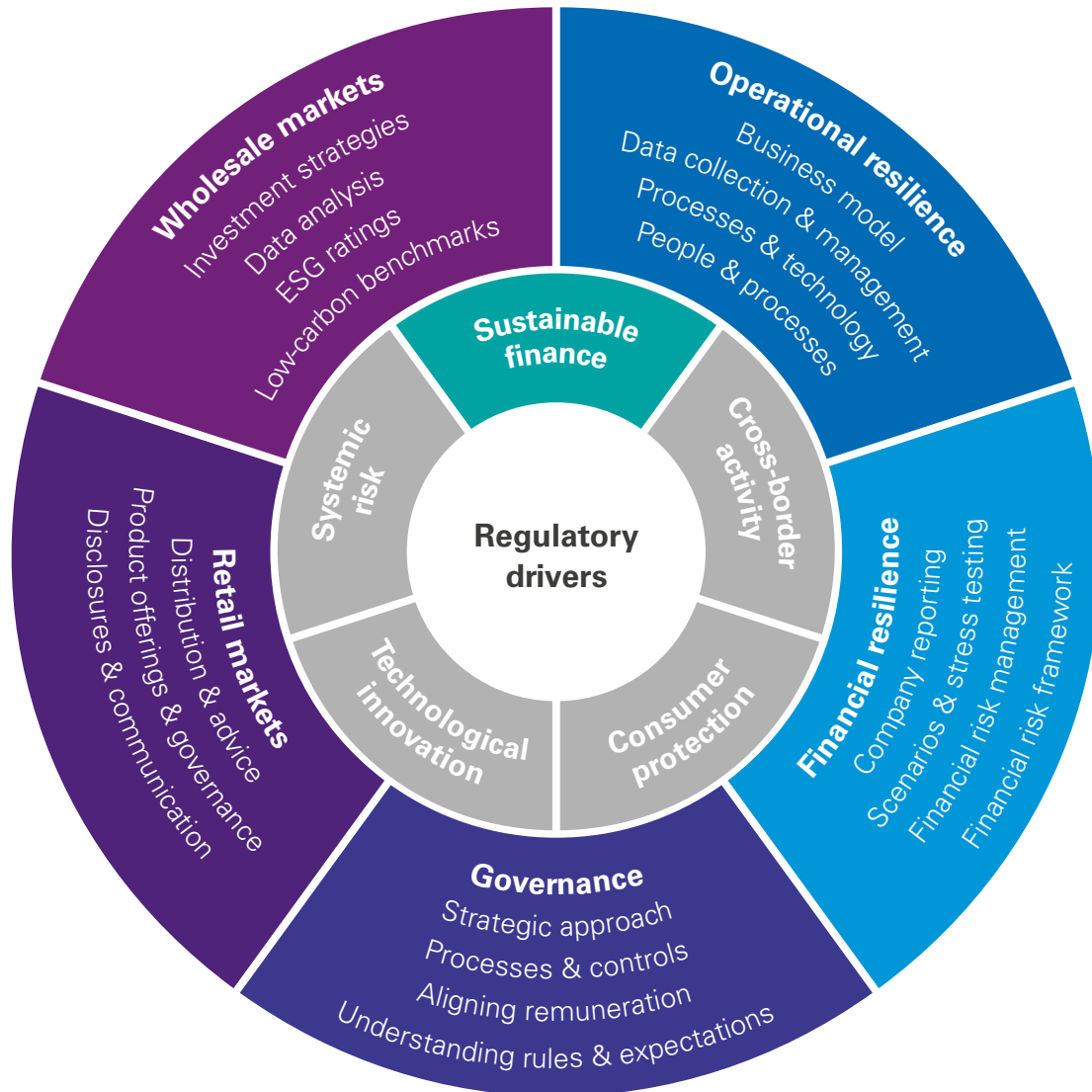
Questions for CEOs to ask

- What is our overall strategic approach on ESG? Have we tested it with all types of stakeholders? What benchmarking have we undertaken?
- Have we considered the range of regulations that will or could impact us, directly or indirectly? What is our roadmap for implementation and is it aligned with our overall approach on ESG? How are we aligning our corporate reporting with regulatory requirements?
- What is our ESG governance structure? Have we identified key performance indicators? What is our process for monitoring and reporting on performance, and for reviewing our policies and processes?
- Have we educated our staff? Have we embedded ESG considerations in our recruitment, performance assessment and remuneration policies and processes?
- How are we embedding ESG factors into our risk framework and stress testing at company level?
- How are we embedding ESG considerations into our businesses activities, including lending decisions, investment process or insurance writing?
- What is our process for gathering and analysing data on underlying assets and exposures, whether at company or product level?
- Do our existing ESG-related products meet the new criteria? What ESG products or services do we wish to offer? How will distributors classify our products? Are our product disclosures and client communications clear and informative?

KPMG professionals have the subject matter expertise and insights to assist you on your ESG journey. For more information, please contact a KPMG professional near you. See the back cover for details.

³ https://ec.europa.eu/info/policies/justice-and-fundamental-rights/gender-equality/gender-equality-strategy_en

Sustainable finance: A key driver influencing regulatory priorities



Five key drivers are influencing priorities in regulatory agendas. Consumer protection and financial stability are the bulwarks of much financial services regulation, but the impacts of the pandemic and lock-down measures have brought additional topics to the fore.

Volatility in capital markets has led to a renewed focus on systemic risk in relation to computer-led trading strategies and certain types of funds. Also, the pandemic has accelerated trends in the use of technology and demands for sustainable finance, and there are new challenges to doing business across borders. These three trends are now equally prominent drivers of regulatory priorities.

01. The search for consistency

Global regulatory bodies have raised concerns about the diverse range of sustainability standards and are calling for consistency. The key to achieving consistency, and to enabling the development of reliable market data, will be standardised definitions of E, S and G. At present, some definitions sit in corporate reporting standards or recommendations, or in established industry practices, such as the UN Principles of Responsible Investment and Sustainable Development Goals. Within the EU, the definition of E is now written into law.

Aiming for global regulation

The International Platform on Sustainable Finance was launched in October 2019 and is supported by various global and European bodies. By July 2020, eleven countries from around the globe had joined the forum. The forum facilitates exchanges and coordinates efforts on initiatives such as taxonomies, standards and labels, and disclosures.

IOSCO's April 2020 report⁴ on sustainable finance and the role of securities regulators indicated a *"broad acknowledgment among regulators, industry participants and other parties that climate-related risks can be material to firms' business operations and investors' decisions"* but raised concerns over the diverse range of sustainability standards. Firms may be subject to different regulatory regimes or participate in multiple initiatives, which can have inconsistent objectives and requirements.

IOSCO warned that the *"wide variety of regulatory regimes and initiatives ... may prevent stakeholders from fully understanding the risks and opportunities that sustainable business activities entail."* The diverse and voluntary nature of ESG disclosure frameworks risks reducing the reliability and usefulness of those disclosures. The report found a lack of a common understanding of what

is meant by sustainable investments and sustainability risks, highlighting the challenges around taxonomies and the lack of agreed, globally-accepted definitions. This risks confusion for regulators, firms and investors, and could aggravate the issues of "cherry picking" of frameworks and "greenwashing".⁵

IOSCO has established a board-level task force on sustainable finance, to play a driving role in global efforts to address these issues. The task force's work includes improving sustainability-related disclosures made by issuers and asset managers and collaborating with other international organisations and regulators to avoid duplicative efforts and to coordinate supervisory approaches.

The EU defines E

The EU Taxonomy Regulation has enshrined in law a definition of an environmentally-sustainable activity. The current focus of the Regulation is on the E of ESG, but the Regulation will be extended also to cover socially-sustainable activities. Meanwhile, both the S and G factors are defined by short references in the separate Sustainable Finance Disclosures Regulation (SFDR) – see Chapter 3.

The Taxonomy Regulation applies to firms that are subject to SFDR and to issuers of financial products

or corporate bonds. It sets out six environmental objectives. For an activity to be environmentally sustainable, it must contribute substantially to one or more of these objectives, not significantly harm any of them, and comply with minimum safeguards and technical screening criteria, which will be set out in more detailed "Level 2" rules.

The European Supervisory Authorities (ESAs) are currently working on their advice to the European Commission

Environmental objectives:

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy, waste prevention and recycling
5. Pollution prevention & control
6. Protection of healthy ecosystems

on those rules, two sets of which will be issued by end-2020 (with the rules applying from January 2022) and the other four by end-2021 (with the rules applying from January 2023). The detailed rules on the technical screening criteria will be critical for firms in knowing how to systematise the requirements. The Technical Expert Group's report⁶ to the Commission on this subject is long – the technical annex alone is 600 pages.

The Taxonomy Regulation also sets out the timeline for the detailed rules underpinning the SFDR and amends the EU's non-financial disclosures requirements (see Chapter 2), thus **creating a direct link between corporate reporting and financial services regulation.**

4 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf>

5 Misleading claims that a product or service is environmentally-friendly

6 https://ec.europa.eu/knowledge4policy/publication/sustainable-finance-teg-final-report-eu-taxonomy_en



02. ESG-related corporate reporting

Standard-setting bodies are seeking to enhance and align their approaches to corporate reporting, both financial and non-financial. Various global initiatives are underway, the European Commission has issued guidelines on non-financial climate-related disclosures and national bodies are refining requirements.

Many financial services firms and some collective investment funds are subject to these requirements, which are focused on climate change but increasingly cover a wider range of ESG factors. The EU Taxonomy Regulation has created a direct regulatory link between corporate reporting requirements and wider ESG financial services regulation.

The global Task Force on Climate-related Financial Disclosures (TCFD) was set up in December 2015 by the Financial Stability Board (FSB) and is tasked with monitoring and making recommendations on risks to the global financial system. By mid-2020, over 1,300 public- and private-sector organisations had announced their support for the TCFD and its work, including many financial services firms.

The TCFD's 11 disclosure recommendations,⁷ which are complemented by seven principles and 50 illustrative metrics, are grouped around four themes:

1. The organisation's governance around climate-related risks and opportunities
2. The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning, where such information is material
3. How the organisation identifies, assesses, and manages climate-related risks
4. The metrics and targets used to assess and manage relevant climate-related risks and opportunities, where such information is material

⁷ <https://www.tcfhub.org/recommendations/>

The TCFD's June 2019 status report⁸ delivered a robust message: disclosures have increased since 2016 but are still insufficient for investors. Michael Bloomberg, TCFD Chair said, "Today's disclosures remain far from the scale the markets need to channel investment to sustainable and resilient solutions, opportunities, and business models".

“disclosures have increased since 2016 but are still insufficient for investors”

Given the urgent changes needed to meet the goals of the Paris Agreement, the TCFD is concerned that not enough companies are disclosing information about their climate-related risks and opportunities. It recognises, however, the challenges that companies face in making such disclosures and encourages them to use its recommendations as a framework to guide their efforts.

Global convergence

Several initiatives are underway, seeking to address the TCFD's concerns.

The International Accounting Standards Board (IASB) is expected to publish by end-2020 an Exposure Draft with updates to the 2010 IFRS Practice Statement 1: Management Commentary. The project, announced in November 2017, is considering how broader financial reporting could complement and support IFRS financial statements. The Board noted that the revision of the Practice Statement is intended to promote preparation of management commentaries that better meet the information needs of the primary users of financial reports. It is expected to provide guidance that:

- consolidates innovations in narrative reporting
- addresses gaps in reporting practice
- remains principles-based but contains sufficient detail to support rigorous application

The Board is also considering how the qualitative characteristics of useful financial information should be considered in preparing management commentaries.

In a speech,⁹ the Chair of the Board, Hans Hoogervorst addressed what sustainability reporting can and cannot achieve, and how it relates to financial reporting. He noted that reporting that helps investors understand how companies are affected by sustainability issues offers a promising step forward, but he cautioned against exaggerated expectations for sustainability reporting as a catalyst for change in the absence of policy and political intervention. "Our Standards do not seek to portray the contribution of a company to the public good, but to provide information that helps investors in their efforts to predict future cash flow of the company itself", he said.

One of Mr. Hoogervorst's key observations was that "there are simply too many standards and initiatives in the space of sustainability reporting. This leads to a lot of confusion among users and companies themselves." The Better Alignment Project of the Corporate Reporting Dialogue was launched to address this issue. Its initial findings in September 2019 noted high levels of alignment between participants' reporting frameworks and the TCFD recommendations, principles and illustrative metrics. The findings indicated the clear and rapid trend, around the globe, to incorporate the TCFD's recommendations.

Other moves include the July 2020 announcement by the Sustainability Accounting Standards Board and the Global Reporting Initiative of a collaborative workplan towards further alignment, and the release of a consultation by the IFRS Foundation in September 2020 to assess the support for it taking on a role in global standard setting for non-financial information focused at investors.

TCFD's seven principles for effective disclosures



Present relevant information



Be specific and complete



Be clear, balanced, and understandable



Be consistent over time



Be comparable among companies within a sector, industry or portfolio



Be reliable, verifiable and objective



Be provided on a timely basis

8 <https://www.fsb.org/wp-content/uploads/P050619.pdf>

9 <https://www.ifrs.org/news-and-events/2019/04/speech-iasb-chair-on-sustainability-reporting/>



EU requirements are linked

Since 2017, the revised EU Non-Financial Reporting Directive (NFRD) has required large entities and groups to include in their consolidated management report specific ESG-related reporting. The Directive applies to public-interest entities that are parent undertakings of a large group that, on its balance sheet date and on a consolidated basis, has an average number of more than 500 employees during the financial year.

The consolidated non-financial statement contains *“information to the extent necessary for an understanding of the group’s development, performance, position and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters”*, including:

- (a) a brief description of the group’s business model
 - (b) the policies pursued in relation to those matters, including due diligence processes implemented
 - (c) the outcome of the policies
 - (d) the principal risks related to those matters linked to the group’s operations including, where relevant and proportionate, its business relationships, products or services that are likely to cause adverse impacts in those areas, and how the group manages those risks
 - (e) non-financial key performance indicators relevant to the business
- Where the group does not pursue policies in relation to one or more of those matters, the consolidated non-financial statement must provide a clear and reasoned explanation for not doing so.
- Entities must also disclose: a description of the diversity policy applied in relation to the undertaking’s administrative, management and

supervisory bodies with regard to aspects such as age, gender, or educational and professional backgrounds; the objectives of that diversity policy; how it has been implemented; and the results in the reporting period. Again, if no such policy is applied, the statement must contain an explanation as to why this is the case.

European Commission guidelines¹⁰ provide practical guidance for firms and integrate the TCFD recommendations ahead of further amendments to the NFRD. The guidelines are intended for use by firms in the scope of NFRD, but they could have wider application. They include recommended climate-related disclosures for each of the Directive’s five reporting areas: **business model; policies and due diligence; outcome of policies; principal risks and risk management; and key performance indicators.**

¹⁰ https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en

¹¹ European Securities and Markets Authority

Firms are expected to follow the recommended disclosures to the extent they are necessary for an understanding of the development, performance, position and impact of their activities. To facilitate consistent reporting at EU and global levels, the guidelines refer to several recognised reporting frameworks and standards, which are within the fold of the Corporate Reporting Dialogue.

ESMA¹¹ has called for general principles and disclosures to be specified, for non-financial statements in companies' annual reports to be subject to assurance and for consistency with the Transparency Directive. The Commission is reviewing the NFRD to ensure a minimum level of comparability, relevance and reliability of current ESG disclosures, and with a view to aligning its requirements more explicitly with the TCFD recommendations.

Meanwhile, the EU Taxonomy Regulation (see Chapter 1) has created a direct link to corporate reporting requirements and wider ESG financial services regulation. It requires all entities within the scope of NFRD to include in their non-financial statements or consolidated non-financial statements information on how and to what extent their activities are associated with economic activities that qualify as environmentally sustainable under the Taxonomy Regulation.

Further specification is expected on the percentage of turnover, capital expenditure and operating expenses related to such activities, which will enable financial services companies to report similar information at the investment and credit portfolio level.

Expanding national requirements

In addition to changes to national corporate reporting standards to implement global and regional recommendations and requirements, jurisdictions around the globe are enhancing their national listing rules and stewardship codes with explicit references to ESG-related disclosures and considerations – for example, in China, Japan and the UK.

The evolving EU ESG regulatory jigsaw





03. Disclosures and benchmarks

The EU's incoming disclosure requirements are extensive. They will impact not only those firms directly in scope but other financial services firms and their products. Likewise, the new low carbon benchmarks and disclosure requirements for all benchmarks will impact not only the benchmark administrators but also enterprises or products that are the constituents of those benchmarks and benchmark users.

In its interim report of July 2017, the European Commission's High Level Expert Group (HLEG) identified two imperatives for Europe's financial system: to strengthen financial stability and asset pricing, by improving the assessment and management of long-term risks and intangible factors of value creation; and to improve the contribution of the financial sector to sustainable and inclusive growth by financing long-term needs and accelerating the shift to a sustainable economy.

In response, the Commission released in May 2018 a package of legislative proposals, all of which have now been adopted:¹²

- Harmonised criteria for determining whether an economic activity is environmentally-sustainable – the Taxonomy Regulation (see Chapter 1)
- Disclosure requirements for institutional investors and intermediaries (SFDR)
- The creation of new categories of low-carbon benchmarks
- Amendments to the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD) to integrate ESG considerations into "suitability" tests (see Chapter 5)

SFDR requires financial market participants and financial advisers to make disclosures on the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of related information on financial products (including funds and pension products).

¹² https://europa.eu/rapid/press-release_MEMO-18-3730_en.htm

Financial market participants must publish on their websites their policies on the integration of sustainability risks in their investment decision-making process. They must also disclose whether they consider adverse impacts of investment decisions on sustainability factors and, if they do, their due diligence policies, including the identification, prioritisation and description of principal adverse sustainability impacts, and action taken or planned. If they do not perform such considerations, they must state that they do not, their reasons for not doing so, and whether and when they intend to do so.

Pre-contractual disclosures must include descriptions of how sustainability risks are integrated into their investment decisions and assessment of the likely impacts of sustainability risks on the returns of financial products, or a clear and concise explanation of why such risks are not relevant.

Financial products that have sustainable investment objectives must disclose methodologies used to assess, measure and monitor the E or S characteristics, or the impact of the sustainable investments. If a product has designated an index, it must disclose how the index is aligned to the objective and why it differs from a broad market index. By 2022, each financial product will have to disclose a clear and reasoned explanation of whether, and if so how, it considers principal adverse impacts of sustainability factors, or why it does not do so.

Also, remuneration policies must be linked to sustainability risks and targets, all policies and documentation need to be reviewed and amended, and both pre-contractual and periodic disclosures to investors will need to be augmented.

The ESAs are considering feedback to draft Level 2 rules to underpin SFDR, which focus on the E and G factors. The proposals include mandatory indicators that firms should always consider as principal adverse impacts (such as greenhouse gas emissions

“ disclosures on the integration of sustainability risks and the consideration of adverse sustainability impacts ”

and lack of adherence to fundamental labour conventions), together with a non-exhaustive set of indicators that might be helpful in identifying, assessing and prioritising additional principal adverse impacts. The draft definition of fossil fuels was criticised by MEPs for excluding oil and gas.

The ESAs will draw up a mandatory reporting template and specify where firms should place disclosures on their websites. Integration of ESG factors into investment processes will not be sufficient to describe a product as promoting environmental or social characteristics, but only where selection criteria for underlying assets apply on a binding basis.

The proposals are prescriptive and will present significant challenges for firms, especially in current operating conditions, but there is no indication that implementation will be delayed. The ESAs recognise, though, that firms will face several practical difficulties:

- lack of data, especially on principal adverse impacts
- that Level 2 rules under the Taxonomy Regulation are awaited
- fitting the additional disclosures into products with length-constrained pre-contractual information documents
- for portfolio managers of separately-managed accounts, balancing the website disclosure requirements with client privacy and data protection rules
- smaller firms may struggle with compliance costs, due to lack of economies of scale

In 2021, the ESAs will draft rules on social issues – the S factor.

A **sustainable investment** is an investment in an economic activity that contributes to:

- an environmental objective, including an environmentally sustainable investment, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or
- a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities;

provided that the investments do not significantly harm any of those objectives and the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of relevant staff and tax compliance.

Sustainability risk is defined as an ESG event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment.

More to come...

The Commission's renewed Sustainable Finance Strategy suggests that asset owners and asset managers should be required, as part of their fiduciary duty, to consider whether their investments are having a negative impact on the environment or society. This approach would go further than the SFDR requirements. The industry has expressed concerns that it would remove choice for investors and contradict a manager's fiduciary duty to those clients.

National approaches to disclosure vary

Ever since the "COP 21" meeting in Paris in late 2015, France has been at the front of the pack for rulemaking. In 2020, it adopted measures to prevent what it calls "ESG washing", defined as broader than greenwashing. The regulator believes a principles-based approach is no longer suitable and now requires the names and documents of funds for which ESG factors are central to comply with a set of standards and thresholds.

The new investor information "doctrine" is intended to help investors – particularly non-professional investors – understand sustainable funds. It requires consistency between what is said within marketing material and what is done in terms of ESG portfolio management. Measurable objectives for sustainability criteria must be included in regulatory documents. Only funds making a "significant commitment" to sustainability themes – measured by reference to the quantitative thresholds of the French SRI (socially responsible investment) label – can present sustainability as a central element of product communication or in the fund name.

The doctrine applied with immediate effect to new funds, modified funds or foreign-domiciled funds registered for sale in France. For products already on sale, the naming and documentation must be updated by end-November 2020.

In contrast, the UK regulators have issued statements of supervisory expectations rather than rules (see Chapter 4 regarding risk frameworks). There is no indication that the UK will implement SFDR or the Taxonomy Regulation, or issue equivalent rules. Instead, the regulators have facilitated an industry forum whose aim is to share best practice and analysis, in order to advance thinking on how firms can better manage the risks posed by climate change and support the transition to a net-zero carbon economy. The forum has produced a detailed guide¹³ containing practical considerations, tools and metrics. It covers climate risk management, scenario analysis, disclosures and innovation. The disclosures section references the TCFD principles (see Chapter 2).

Low-carbon benchmarks

New rules on benchmarks will impact benchmark providers, constituents of those benchmarks and benchmark users. The EU Benchmarks Regulation has been amended to include references to "low-carbon benchmarks" (which have fewer

carbon emissions compared to a standard capital-weighted benchmark) and "positive carbon impact benchmarks" (for which the underlying assets are selected on the basis that their carbon emissions savings exceed the assets' carbon footprints). Two new benchmarks have been created: the EU Climate Transition Benchmark (CTB) and the EU Paris-aligned Benchmark (PAB).

For each benchmark or family of benchmarks (excluding currency and interest rate benchmarks), an explanation must be given of how the key elements of the methodology reflect ESG factors. Exclusions will include, for example, companies that are associated with a level of carbon footprint or fossil fuel reserves that is incompatible with inclusion in the benchmark. If a benchmark does not pursue ESG objectives, this must be clearly stated. Further detail is specified in the Level 2 rules issued in July 2020. These cover the minimum requirements for the construction of the two new benchmarks and minimum ESG disclosure requirements that will apply to all benchmarks, with some exceptions.

New EU benchmarks

CTB: The underlying assets are "selected, weighted and excluded in such a manner that the resulting portfolio is on a decarbonisation trajectory":

- (i) the companies disclose measurable and time-based carbon emission reduction targets to be achieved within specific timelines
- (ii) the companies disclose a carbon emission reduction, which is disaggregated down to the level of relevant operating subsidiaries
- (iii) the companies disclose annual information on progress made towards those targets
- (iv) the activities of the underlying assets do not significantly harm other ESG objectives

A decarbonisation trajectory means a "measurable, science-based and time-bound trajectory towards alignment with the Paris Agreement by reducing Scope 1, 2 and 3 carbon emissions".

PAB: The underlying assets are "selected in such a manner that the resulting benchmark portfolio's carbon emissions are aligned with objectives of the Paris Agreement."

¹³ <https://www.fca.org.uk/transparency/climate-financial-risk-forum>

04. Incorporating ESG into risk frameworks

There is increasing pressure for firms and investment funds to incorporate ESG risks into their overall risk frameworks and activities. Also, supervisors are expecting banks and insurers to consider the full panoply of climate-change risks in their stress-testing exercises, and there is consideration of explicit changes to capital requirements.

Back in July 2018, the International Association of Insurance Supervisors (IAIS) and the Sustainable Insurance Forum (SIF) published an issues paper¹⁴ on climate change risks to the insurance sector. To support supervisory efforts to assess the impact of climate-related risks to the sector and help resolve challenges, the two bodies continue to work on this topic, including enterprise risk management, corporate governance, investment and disclosures.

In April 2020, the Basel Committee published a stocktake report¹⁵ prepared by its high-level Task Force on Climate-related Financial Risks. The report noted that most BCBS members are undertaking regulatory and supervisory initiatives on climate-related financial risks, and that future work includes analytical reports and developing effective supervisory practices.

In May 2020, the Central Banks and Supervisors Network for Greening the financial System (NGFS) published a guide¹⁶ for supervisors on integrating climate change into prudential supervision. It provides a snapshot of the state-of-play in several countries and sets out five non-binding recommendations for supervisors, intended to co-ordinate a common regulatory response to climate-related and environmental risks.

14 <https://www.iaisweb.org/page/supervisory-material/issues-papers/file/76026/sif-iais-issues-paper-on-climate-changes-risk>

15 <https://www.bis.org/press/p200430.htm>

16 https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf

NGFS recommendations to supervisors

- Determine how climate-related and environmental risks transmit to the economy and financial sectors in the jurisdiction and identify how they are likely to be material for supervised entities.
- Develop a clear strategy, establish an internal organisation and allocate adequate resources to address these risks.
- Identify the exposures of supervised entities that are vulnerable to these risks and assess potential losses should they materialise.
- Set supervisory expectations to create transparency for financial institutions in relation to the supervisors' understanding of a prudent approach to these risks.
- Ensure adequate management of these risks by financial institutions and take mitigating action where appropriate.

Translation into rules and expectations

On the back of the IAIS/SIF issues paper and subsequent recommendations by EIOPA,¹⁷ the European Commission consulted in June 2020 on proposals to integrate sustainability risks and factors into the Solvency II Level 2 rules. The amendments will require insurers to reflect sustainability risks in their risk management, take account of sustainability risks in the assessment of uncertainty associated with estimates made in the calculation of technical provisions, incorporate sustainability risks in the application of the prudent person principle and include information in their remuneration policies on how they take account of sustainability risks.

The Commission will take account of EIOPA's opinion on the impact of Solvency II on insurers' sustainable investment and underwriting activities as part of its overall report on the Solvency II regime, due in January 2021.

The Commission also consulted in June 2020 on proposals relating to the managers of UCITS and alternative investment funds (AIFs) and MiFID II investment firms. In addition to clarifying implications for such firms of the SFDR (see Chapter 3) and articulating requirements relating to product governance and suitability (see Chapter 5), they will require

sustainability risks to be incorporated into fund managers' investment risk frameworks and investment firms' organisational arrangements. Further, AIF managers should consider conflicts of interest that may arise as a result of the integration of sustainability risks in their processes, systems and internal control. This might include, for example, conflicts arising from remuneration or personal transactions of relevant staff, conflicts that could give rise to greenwashing, mis-selling or misrepresentation of investment strategies, or conflicts between different AIFs managed by the same firm.

The Commission issued a tender for work on integrating ESG risks into banks' risk management processes and EU prudential supervision, and integrating ESG objectives into banks' business strategies and investment policies. Meanwhile, the ECB is consulting until September 2020 on a guide¹⁸ on how it expects banks to manage climate-related and environmental risks safely and prudently and to disclose these risks transparently under the current prudential framework. The guide includes supervisory expectations on governance and risk management frameworks, the formulation and implementation of business strategies, and enhanced disclosures. Significant institutions are expected to review and, where needed, adapt their practices.

As part of the supervisory dialogue, from end-2020 significant institutions will be asked to inform the ECB of any divergences of their practices from the supervisory expectations described in the guide. Failure to respect the guide may result in additional supervisory measures, in the form of capital add-ons. The ECB acknowledges that the management and disclosure of climate-related and environmental risks, and the methodologies and tools used to address them, are currently evolving and are expected to mature over time.

Ahead of the ECB consultation, in April 2019 the UK's Prudential Regulatory Authority (PRA) set out its expectations¹⁹ for banks and insurers to draw up credible plans to protect themselves from financial risks associated with climate change. This was followed by a Dear CEO letter in July 2020 further building out expectations of firms, providing observations on good practice and setting out next steps for implementation.

Firms will need to embed climate change within the existing governance framework and assign board-level accountability for oversight. Chief Risk Officers will need to consider long-term scenario testing to inform the firm's strategic response to climate change and build climate-change risks into risk management processes. The PRA expects firms to have fully embedded their approaches to managing climate-related risks by end-2021.

Stress testing – a new challenge

Central banks are assessing the impact of adverse climate scenarios on bank capital adequacy.

In the UK, for example, firms are expected to understand the impact of climate-related and environmental risks on the business environment in which they operate, in the short, medium and longer term, in order to be able to make informed strategic and business decisions. Climate-transition scenarios were included in the 2019 Insurance Stress Test for life and general insurers.

¹⁷ European Insurance and Occupational Pensions Authority

¹⁸ <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr.200520--0795c47d73.en.html>

¹⁹ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319>

The key findings, issued in June 2020,²⁰ included that firms need: to enhance their capabilities (tools, data, expertise); to develop their modelling of risks as they crystallise over the medium to long term; and to embed their risk frameworks and engage different parts of their business (i.e. the risk function should not work in isolation).

In its December 2019 Discussion Paper,²¹ the Bank of England set out the narratives, specification and modelling approaches to three climate-risk scenarios – “orderly”, “disorderly” and “hot-house world” – intended to be the focus of the 2021 Biennial Exploratory Scenario (BES). It also provided five alternative scenarios to help users assess the effects of different key assumptions.

The BES is on hold due to COVID-19, but is expected to go ahead in due course. It aims to test the resilience of the largest banks’ and insurers’ current business models to climate-related risks and inform assessment of the scale of adjustment required to ensure that the financial system remains resilient in the coming decades. Although the first climate-related BES for banks will be a learning exercise, the delay may result in greater expectations of firms.

Stress-testing developments at EU or wider level were slower to emerge but are now gaining momentum. The ECB consultation encourages banks to develop stress-testing scenarios that incorporate climate-related and environmental risks. Institutions with

material risks are expected to evaluate the appropriateness of their stress testing, with a view to incorporating them into their baseline and adverse scenarios. The 2019 EBA workplan on sustainable finance²² committed it to developing dedicated climate-related stress tests.

Firms and regulators are aware of the significant challenges involved. Quantification of climate risk is complex due to the longer than usual time horizons involved, and methodologies and tools to estimate scale and impact of climate-related risks are still evolving.

Nevertheless, firms are expected to act, and to act now.

Impact of EU ESG requirements by firm type

Requirement	Listed companies	Private entities/projects	Retail banks	Investment banks Wholesale brokers	Life insurers	General insurers	Asset managers	UCITS, AIFs & managers	Advisers Stockbrokers Platforms	Benchmark providers
Taxonomy Regulation	Bond issuers	If held in AIFs or pensions								
Non-Financial Reporting Directive	Depends on size	Some					Some	Some funds	Some	
Sustainable Finance Disclosures Regulation:	– for firms	If held as investments	If held in AIFs	If offer financial advice or portfolio management	If offer financial advice				If offer financial advice	
	– for products	If held within products	If held in AIFs			Insurance-based inv't & pension products		In portfolios		
Benchmarks Regulation			Listed banks	Listed banks	Listed insurers	Listed insurers		Listed funds		
Risk frameworks	Bank funding & trading Insurance	Bank funding Insurance								
Stress testing										
MiFID II and IDD suitability rules	If held as investments	If held in AIFs						When held as investments		
Green Bond Standard (in draft)	Bond issuers		Bond issuers	Bond issuers	Bond issuers		Bond investments	Bond investments	Bond investments	
Eco-label for retail investment products (under design)			Retail products	If offer retail products	Retail products			Retail funds		

■ Direct impact (i.e. the rules apply to those firms)

■ First order indirect impact (i.e. the application of rules on other entities will or could impact these firms)

20 <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/insurance-stress-test-2019-feedback.pdf>

21 <https://www.bankofengland.co.uk/-/media/boe/files/paper/2019/the-2021-biennial-exploratory-scenario-on-the-financial-risks-from-climate-change.pdf?la=en&hash=73D06B913C73472D0DF21F18DB71C2F454148C80>

22 <https://eba.europa.eu/eba-pushes-early-action-sustainable-finance>

05. Product governance and distribution

The first EU legislative package includes requirements for firms to consider ESG factors in their product governance processes and suitability assessments. The Commission is now working on new product labels and standards for green bonds and Eco-products.

Suitability tests

The European Commission's May 2018 package of legislative proposals included amendments to MiFID II and the Insurance Distribution Directive (IDD) to integrate ESG considerations into "suitability" tests. Intermediaries must seek information about and have regard to clients' ESG preferences.

The Commission consulted²³ for one month on draft Level 2 rules on the integration of sustainability factors under UCITS, the Alternative Investment Fund Managers Directive (AIFMD), MiFID II, IDD and Solvency II. The rules require firms to consider clients' ESG preferences in suitability assessments and to embed consideration of ESG factors into their product governance and risk management processes. The rules are based on advice to the Commission from the ESAs.

In its advice on amendments to the Solvency II Directive and IDD, EIOPA noted, "*The assessment of sustainability risks requires deep knowledge of the undertaking's business, the external environment and the interaction between both. For such purpose, relevant knowledge may include a wide range of different areas such as ecology, law, sociology, financial markets, among others*".

ESMA has established a Coordination Network on Sustainability, which will work with national regulators on policy development and integration

of sustainability considerations in financial regulation. Its advice to the Commission on Level 2 amendments to MiFID II included:

- Taking ESG preferences into account when assessing clients' investment objectives and in product classification
- Requiring managers of UCITS and AIFs to incorporate sustainability risks into their internal procedures and investment processes, and to identify and manage conflicts of interest

Asset managers will have to set up new controls and potentially hire more staff, ESMA said, noting that firms need to have "*sufficient human and technical resources for the assessment of sustainability risks*".

New product labels

The Commission is considering the introduction of an eco-label to encourage retail savers to buy green investments and is consulting²⁴ on an EU Green Bond Standard (GBS) and whether a similar standard should be developed for social bonds.

The Joint Research Centre (JRC) proposed mandatory criteria for determining whether retail financial products (investment funds, insurance-based investment products and savings accounts/deposits) can use the EU ecolabel. The ecolabel will apply to the service provided by the

The GBS is based on four components:

1. Alignment of the use of the proceeds from the bond with the EU Taxonomy
2. The publication of a Green Bond Framework
3. Mandatory reporting on the use of proceeds (allocation reports) and on environmental impact (impact report)
4. Verification of compliance with the Green Bond Framework and the final allocation report by an external registered/ authorised verifier

product manufacturer, rather than to the product itself, but can feature on the product's promotional material. The JRC sought to find a balance between allowing too many investment products to claim green status and excluding too many existing products that are currently advertised as green. It suggests that bond funds be at least 70%-invested in bonds that comply with the GBS, that a "three-pocket" approach be adopted for equity funds (which may be difficult to operate in practice), and that insurance unit-linked products should look through to the underlying funds.

The GBS would apply to any type of issuer: listed or non-listed, public or private, European or international. There will be criteria for determining which climate and environmentally-friendly activities should be eligible for funding via an EU green bond. The proposed contents of the Green Bond Framework and of the "allocation" and "impact" reports are as recommended by the Technical Expert Group in its detailed report of March 2020.²⁵

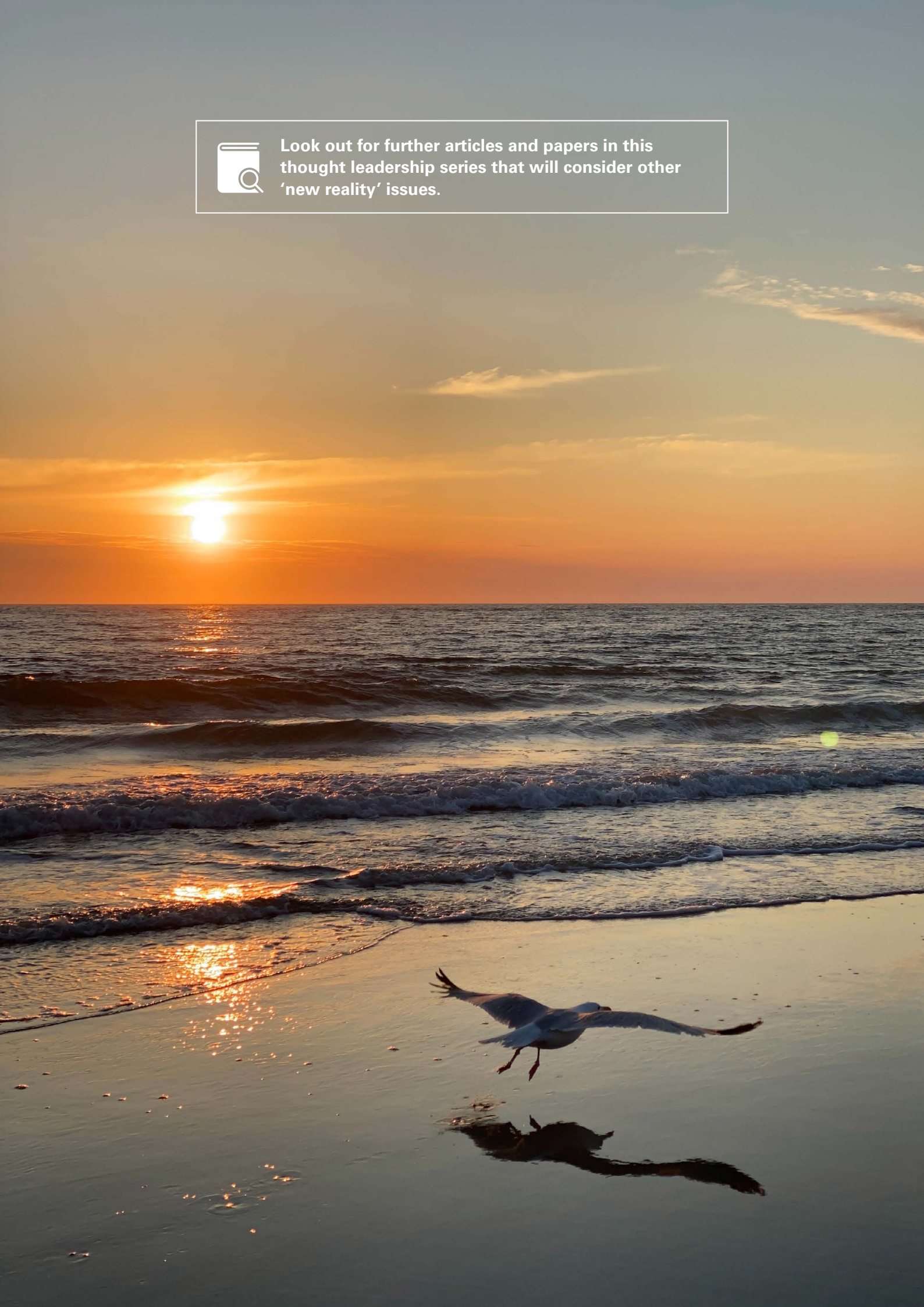
²³ <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12067-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Directive-EU-2017-593>

²⁴ https://ec.europa.eu/info/consultations/finance-2020-eu-green-bond-standard_en

²⁵ https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf



Look out for further articles and papers in this thought leadership series that will consider other 'new reality' issues.



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