ESG Regulatory Essentials

Issue 1 – December 2021 – FS Regulatory Insight Centre

Welcome to the first edition of ESG Regulatory Essentials.

This is a new regular publication from KPMG's EMA Financial Services Regulatory Insight Centre, providing a summary of the latest **ESG regulatory developments impacting financial services firms.**

As we approach the year end, it's time to take stock of recent developments in ESG regulation. Unsurprisingly given the momentum around COP26, there has been a rush of climate-related regulatory updates and announcements. Regulators have continued to develop, and expand on, their guidance and requirements across disclosures, supervisory expectations, stress testing, and possible future capital requirements.

The COP26 meeting in Glasgow put the "E" front and central, triggering announcements such as the creation of an International Sustainability Standards Board, mandatory net zero transition plans for all UK listed firms from 2023 and reaffirmation of the NGFS members' commitments to meeting the 2015 Paris Agreement objectives.

Work continues to develop ESG frameworks and standards - at a global level, IOSCO has published recommendations for national regulators and policy makers in the asset management industry and called for oversight of ESG ratings and data product providers. The Basel Committee is consulting on draft principles for banks and supervisors for the effective management and supervision of climate-related financial risks. And the IAIS has committed to urgently advance work to address risks and opportunities associated with climate change.

Key developments

- Creation of International Sustainability Standards Board (ISSB)
- Mandatory transition plans for UK companies
- IOSCO – recommendations for asset management regulators and policy-makers
- IOSCO – calls for oversight of ESG ratings and data product providers
- BCBS draft principles for the effective management and supervision of climate-related financial risks
- EC – CRR3/CRD6 introduce new ESG requirements
- EC – SFDR delegated act deferred to 1 January 2023
- Introduction of UK Sustainability Disclosure Requirements (SDR)
- EIOPA sustainability mandates under Solvency II
- Stress testing progresses for banks and insurers
- 2022 supervisory expectations emerge

The European Commission's new banking package introduces further ESG requirements for banks and the Commission also proposes new sustainability mandates for EIOPA under Solvency II.

The European Supervisory Authorities have delivered draft Regulatory Technical Standards for disclosures under the Sustainable Finance Disclosure Regulation (SFDR), EIOPA has announced that in 2022 it will finalise the first Europe-wide dashboard on the natural catastrophe protection gap, and the ECB has shared the findings of its 2021 supervisory review work and published its stress testing methodology for 2022.

And in the UK, the government has launched its roadmap for sustainable investment, the first phase of which includes new Sustainability Disclosure Requirements and customer facing investment labels.

The Climate Financial Risk Forum has issued further guidance for banks, insurers and asset managers.

Financial regulators have also published their climate adaptation reports including supervisory expectations for 2022 – with particular focus on evolving capital requirements (PRA) and transition plans (FCA). Banks and insurers have made their first CBES stress test submissions.

For more on these developments, please read on.

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COP 26

The United Nation's Climate Summit, COP 26 (the 26th Climate Change Conference of the Partners), from 31 October to 12 November, aimed to solidify the plans set out in the 2015 Paris Agreement by:

1) Securing the reduction of global carbon emissions to net zero by 2050
2) Adapting and protecting communities and ecosystems
3) Mobilizing the public and private climate finance required to secure net zero

For a summary of the implications for businesses, achievements and shortcomings of COP26, see KPMG Impact's paper.

Several regulators and financial services industry bodies used the platform and attention afforded by the summit to make significant announcements relating to climate risk.

The IFRS Foundation announced the formation of a new International Sustainability Standards Board (ISSB) to develop a "comprehensive global baseline of high-quality sustainability disclosure standards" for financial markets. The standards will aim to combat accusations of greenwashing, fill remaining data gaps and enable investors and other stakeholders to compare sustainability performance and related risks in a more meaningful way. They will be voluntary but are expected to be adopted by companies in Q3 or Q4 2022.

Prototype requirements, for climate and general sustainability disclosures have already been provided to the ISSB for consideration.

The IFRS Foundation will complete the consolidation of the Climate Disclosure Standards Board (CDSB), an initiative of the Climate Disclosure Project (CDP), and the Value Reporting Foundation (VRF), which houses the Integrated Reporting Framework and SASB Standards, by June 2022.

This is designed to ensure that the new ISSB Board builds on these existing disclosure frameworks to ease the process for corporates.

The **Network for Greening the Financial System (NGFS) published its Glasgow Declaration.** This reiterates the readiness of central banks and supervisors to contribute to meeting the objectives of the 2015 Paris Agreement through enhanced efforts such as further development of climate scenarios, intensifying work to bridge data gaps, supplementary guides on TCFD-aligned reporting for central banks, facilitating improvement and consistency in supervisory practices and exploring emerging climate-related risks to financial systems.

A further key announcement impacting financial firms was the requirement for all listed companies in the UK to develop transition net-zero transition plans by 2023. This will increase transparency and make clear which companies have credible plans and which do not. The requirement is likely to be replicated in other countries.

UK updates

As part of its proposals for how UK regulation will be made in the future, the UK Treasury plans to amend the existing regulatory principle for sustainable growth to reference climate change and a net zero economy for the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). This is intended to increase the accountability of regulators to government, parliament and stakeholders.

The UK's Climate Financial Risk Forum (CFRF) published a second round of guidance to support financial services firms as they develop their approaches to addressing climate-related risks and opportunities.

The CFRF, established in March 2019 by the PRA and the FCA, includes representatives from banks, insurers and asset managers, and aims to share **best practice and analysis "by industry, for industry"**.

The first round of guidance was published in June 2020. The Session 2 guides are based on outputs of the CFRF's Working Groups and expand further the thinking around risk management, scenario analysis, disclosure, innovation and climate date and metrics. They also provide case studies, implementation guides and commentaries. For more details see our article.

The UK's financial regulators have responded to the Government's request for Climate Change Adaptation reports. The reports focus on the current and future predicted impact of climate change in relation to the regulators' functions, their proposals and policies for adapting to climate change, and an assessment of progress against previous commitments and targets.

In Focus - Climate Adaptation Reports

The FCA report identifies a "broader risk of financial loss for consumers where firms do not sufficiently consider climate risk", whether through the physical effects of climate change on asset values or through loss of money or access to products where firms fail to adapt to the evolving policy environment. It considers how firms plan to transition to net zero and the role of capital mobilisation in financing climate change adaptation and climate change mitigation.

Projects considering net zero will form a significant part of the FCA's sustainable finance programme going forward, through work with HM Treasury to support firms with their transition plans, continuing focus on net zero investor stewardship and research on capital mobilisation. Work to develop solutions to ESG data and disclosure issues will begin in Q1 2022. Firms are encouraged to ensure that their net zero commitments are **appropriate, achievable and accountable**.

The **PRA report** notes a significant change in the way firms' leaderships recognise the risks associated with, and firms' responsibilities to, mitigating climate change, but finds that further progress is required, particularly in risk management and scenario analysis functions.

In 2022, all elements of the supervisory review cycle will include consideration of climate-related risks. The PRA will exercise its expanded range of supervisory powers where firms are not deemed to have made sufficient progress, including risk management- and governance-related capital scalars, capital add-ons or s166 'Skilled Person' reviews. Firms will be assessed against the requirements of SS3/19, and larger firms' processes for compiling ICAAP or ORSA regulatory returns will be reviewed.

Existing **ICAAP and ORSA frameworks are only partially adequate in capturing the effects of climate risk for regulatory capital purposes** and the PRA sets out possible solutions including further add-ons for firms with significant weaknesses, amendments to frameworks or calculations and a system-wide capital buffer.

In 2022, the PRA will determine whether **capital changes** are best enforced through modifications to internationally-driven or domestic Pillar 2 requirements and will determine what changes are required to insurers' Solvency Capital Requirement (SCR) calculations.

Firms should also expect an update on future climate scenario exercises, a possible consultation on regulatory returns and a review of SS3/19 disclosures.

Banks

The Basel Committee for Banking Supervision (BCBS) is consulting until February 2022 on new principles for the effective management and supervision of climate-related financial risks. There are 18 high-level principles, 12 for banks and 6 for prudential supervisors across corporate governance, internal controls, capital and liquidity adequacy, risk management, and monitoring and reporting.

The principles have been designed to accommodate a diverse range of banking systems and are **intended to be applied on a proportionate basis** depending on the size, complexity and risk profile of the bank or banking sector for which an authority is responsible. They are high-level and it is therefore expected that they can be implemented while also meeting local and/or regional supervisory expectations.

BCBS will monitor implementation of the principles across member jurisdictions to promote a common understanding of expectations, support the development of harmonised practices and facilitate adoption as soon as possible.

There are new ESG requirements under the 2021 EU banking package:

CRD6 proposes **a horizon of at least 10 years for** business strategy, planning and scenario analyses, in line with the EBA's June 2021 recommendation. A new minimum frequency is included, with plans to be reviewed at least every 2 years. Banks will be expected to **identify, measure, manage and report on ESG risks and develop quantifiable targets** to monitor them**.** The EBA is tasked with developing specific guidelines.

CRD6 also introduces incentives for banks to align their strategies with the objectives of initiatives such as the EU Green Deal and EU Sustainable Finance Strategy, with **powers for supervisors** to intervene in case of misalignment. The EBA will develop further guidelines on the content of business plans.

CRR3 introduces a **harmonised definition of ESG risks**, again consistent with the EBA's June 2021 definition. Environmental risks include factors explicitly related to the six objectives of the EU Taxonomy. ICLAAPs are to consider ESG risks for short, medium and long-term (greater than 10 years) horizons.

The EBA will develop **specific guidelines on climate related stress testing**, update standards on supervisory reporting to include exposures to ESG risks and extend application of Pillar 3 disclosures to a significantly larger set of banks.

The delivery date for the **EBA's report on the classification and prudential treatment of assets** from a sustainability perspective has been brought forward from 28 June 2025 to 28 June 2023. ESG risks will also be integrated in the Supervisory Review and Evaluation Process (SREP).

The European Central Bank (ECB) has published its climate stress test methodology ahead of the 2022 exercise. Results are expected to be published in July 2022 and will inform the SREP through a qualitative approach. The main goal of the exercises is to **assess European banks' climate risk stress test capabilities - and their vulnerabilities to transition and physical risks** - under certain assumptions and a range of climate scenarios.

In December 2021, the ECB will host a workshop with in-scope banks. Final versions of the methodology and data templates, together with the scenarios, will be published shortly before the exercise begins. For more details on the challenges for banks, see the KPMG ECB Office's article here.

The ECB has also published a report on the state of climate and environmental risk management in the banking sector.

Of the 112 significant institutions asked to self-assess against the ECB's 13 supervisory expectations for climate and environmental (C&E) risk management, the ECB found that none were close to fully aligning practices with supervisory expectations and that **most are still in the early stages of development**:

- Most expect C&E risks to have a material impact on their risk profile in the coming three to five years and roughly half expect a material impact in the short-to-medium term. Credit, operational and business model risks are seen as being most sensitive to C&E risk drivers.
- Management bodies are increasingly taking formal responsibility for C&E risk, but most banks have not developed the relevant risk reports
- Few banks have made any effort to take stock of the type of data they would need in order to identify and report internally on C&E risks
- More than half of banks have described C&E risks in their risk inventory, but less than one-fifth have included dedicated C&E key risk indicators in their risk appetite statement
- Some have started to consider how to align their financing with the Paris Agreement while avoiding an excessive build-up of transition risks
- Most institutions have a blind spot for physical risks and other environmental risk drivers, such as biodiversity loss and pollution
- Almost all banks have developed implementation plans to improve their practices, but the quality of the plans varies considerably.

Some good practices were identified, but in most cases progress remains slow. The **ECB expects all institutions to take decisive action to address the shortcomings** set out in a dedicated supervisory feedback letter. For some banks, a qualitative requirement may be communicated as part of the 2021 SREP.

Capital markets

ESMA has put out a preliminary report on the EU carbon market. This presents an **overview of the financial regulatory environment for the carbon market** under MAR, MiFID II and EMIR and the tools available to securities supervisors to fulfil their responsibilities. It also provides an analysis (based on commercial data) of price evolution and volatility in European Emission Allowances (EUAs) and derivatives on EUAs. EMA will carry out further in-depth analysis before presenting its final report to the EU Commission in 2022. The EU will then assess whether targeted actions are needed in the EU carbon market.

IOSCO has called for oversight of ESG Ratings and Data product providers and published a set of recommendations (following its July consultation). The aim is to **increase trust in ESG ratings and data** going forward. There are 10 recommendations in all across: possible regulatory and supervisory approaches, internal processes for ratings and data providers, use of ratings and data products and the interactions of ESG ratings and data product providers with entities subject to assessment such providers

Given that this part of the market does not currently fall within the typical remit of securities regulators, IOSCO has sought to strengthen its knowledge by undertaking a fact-finding exercise with ESG ratings and data products providers, users of ESG ratings and data products, and the companies that are the subject of these ESG ratings or data products.

Asset Owners & Asset Managers

The UK Government has set out its "Roadmap to Sustainable Investing", the first phase of which requires development of an integrated UK framework for disclosures, the new Sustainability Disclosure Requirements (SDR), and customer-facing investment labels.

SDR will **expand on the UK's TCFD implementation** and will cover corporate, asset manager, asset owner and investment product disclosures. Asset managers, asset owners and investment products will be required to substantiate ESG claims in a way that is **comparable between products and accessible to clients and consumers**. They will also need to disclose whether and how they take ESG-related matters into account in governance arrangements, investment policies and investment strategies.

The framework will use consistent approaches and metrics across the economy, aligned to international standards where possible to support international compatibility. SDR will **integrate the global standards to be developed by the ISSB** in 2022, which themselves will build on the four pillars of the TCFD recommendations. Under SDR, firms will also be **expected to disclose against the UK Green Taxonomy**. For more on these initiatives, see our article here.

The **FCA has issued a discussion paper on the SDR and customer-facing investment labels.** SDR will be of particular relevance and challenge to firms also subject to the EU's SFDR. The FCA recognises this and is therefore asking for views on the extent to which UK policy can remain as consistent as possible with SFDR, while reflecting the needs of the UK market. The feedback window closes on 7 January 2022 with further consultation expected in Q2 2022 before final policy is agreed.

For further information, see our article.

SFDR - the European Commission has informed the Parliament and Council that the additional SFDR RTS, as required by the amendments to SFDR under the Taxonomy Regulation and as presented by the European Supervisory Authorities (ESAs) in October 2021, are too long and technical to be adopted within the usual three-month period. Also, they are to be bundled together with the first set of SFDR RTS proposed by the ESAs. The **application of this single delegated act will therefore be deferred by six months to 1 January 2023**.

Company-level disclosures on principal adverse impacts will be required from June 2023, but the first reference period will be the calendar year 2022. Therefore, firms need to collect PAI data from January 2022.

Asset Managers

In November, IOSCO published recommendations on sustainability-related practices, policies, procedures and disclosures for national regulators and policy makers in the asset management industry. The recommendations are in five parts and cover: setting of regulatory expectations around practices, policies and procedures, clarification and guidance to include product-level disclosures; supervisory and enforcement tools; encouraging common terms and definitions; and educating financiers and investments. IOSCO notes that setting regulatory and supervisory expectations will help address the need for consistent, comparable, and decision-useful information, allow investors to understand the impact of their investments and reduce the risk of greenwashing.

Securities regulators and policymakers should **use the recommendations to identify areas for consideration within their domestic mandates and regulatory frameworks**.

In Focus - IOSCO recommendations

(1) Securities regulators and policymakers should set regulatory and supervisory expectations for asset managers in respect of:

- Material sustainability-related risks for all products.
- The development and implementation of practices, policies and procedures relating to material sustainability-related risks and opportunities
- The disclosure of these practices, policies and procedures, as well as the nature of material risks and opportunities

(2) Securities regulators and policymakers should clarify and expand on existing regulatory requirements/ guidance or create new regulatory requirements or guidance, to improve product-level disclosures which help investors to understand:

- Sustainability-related products

(3) Securities regulators and policymakers should have supervisory tools to monitor and assess whether asset managers and sustainability-related products comply with regulatory requirements. Enforcement tools should be in place to address any breaches of requirements.

(4) Securities regulators and policymakers should encourage industry participants to develop common sustainable finance-related terms and definitions, including relating to ESG approaches, to ensure consistency throughout the global asset management industry.

(5) Securities regulators and/or policymakers should educate financiers and investors as to sustainability issues or enhance existing educational initiatives.

Insurers

The IAIS issued a statement ahead of COP 26 confirming that it will urgently advance work to address risks and opportunities associated with climate change. It will seek to assist both supervisors and firms, and to ensure a consistent approach.

Under its Solvency II proposals, the European Commission proposes to give EIOPA a mandate to consider whether a **dedicated prudential treatment of exposures** to assets and activities associated with environmental and/or social objectives would be justified, and to submit a report the Commission on its findings by end-June 2023.

EIOPA is also required to **review the scope and calibration of standard formula parameters** with respect to natural catastrophe at least every three years, taking into account the latest available evidence on climate science.

EIOPA has welcomed the European Commission's proposals - it believes they will, more generally, contribute positively to a transition into a more sustainable economy and that insurers, in their role as investors and risk managers, can facilitate it.

In addition, EIOPA has announced that in 2022 it will finalise the **first Europe-wide dashboard** on the natural catastrophe insurance protection gap. The dashboard will raise the awareness on the role of insurance against climate related perils and inform policy measures and private sector initiatives to secure the future availability and affordability of insurance coverage.

For more on regulating for climate change in insurance see our latest article.

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