brownejacobson LLP

ESG

in 3D

A monthly digest of key publications, legal and regulatory development and commentary relating to:

- Climate change & the environment
- Social impact
- Corporate governance
- Sustainability and
- Responsibility

For corporates and individuals in the financial services, insurance, markets and beyond…

Enhancing conduct, culture and capital in a changing environment.

December 2021 Issue 03

Introduction

Welcome to the third edition of 'ESG in 3D', covering developments and emerging trends in environmental, social & governance (ESG) and sustainability & responsibility (S&R).

Our teams specialising in ESG strategy, opportunities and risks can help with all the practical challenges facing corporates, individuals, financial services and insurance participants and the rest of the world including, as highlighted in this month's articles which focus on the opportunities and challenges arising from COP26.

This month:

- Our guest writer, Tom Spraggs from Protean Risk on what ESG means for insurance
- Kirsty Finlayson, COP26 and the "forest promises"
- Ben Standing on the battle against coal
- Jeniz White on remuneration from a social perspective
- Jeremy Irving on ESG compliance and regulation, insurer culture and conduct risks and Sustainability labelling

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Sharing the spotlight

The articles we have produced shed light on our approach to addressing the depth, breadth and inter-connectedness of ESG/ S&R.

We have selected a handful of announcements and other publications that relate to each of the ESG dimensions, giving their context, highlighting the potential consequences for businesses and commenting on their broader ramifications.

Some cases involve more than one dimension of ESG. Where this is the case, we have outlined the impact on each dimension and used the Venn diagram below is used to illustrate to which dimensions we are referring.

Contents

ESG from a broker perspective

Digest:

- Carbon-intensive industries and investment companies may be held personally accountable for failing to consider climate change.
- Directors need cover to protect themselves from emerging risk exposure.

ESG – what it means for your insurance

Source/Context:

The landscape for third-party claims has developed over the past couple of years. With emerging and constantly evolving risk exposures such as cyber-attacks, directors and officers need to ensure they have the necessary cover in place to protect them from liability arising from the management of such risk. With the environmental sustainability of companies now thrust into question, the directors and officers of carbon-intensive industries and investment companies may be held personally accountable for failing to consider the impact of climate change in their corporate strategy and decision-making. This could also extend to failure to disclose information relating to climate-related risks. Allegations of wrong doing in this respect could incur legal costs or regulatory investigation expenses, which can be accommodated under a Directors' and Officers' Liability policy if such exposures have been disclosed during the placement of the coverage.

According to a recent Blackrock survey, 78% of insurance companies believe COVID-19 has accelerated their focus on ESG, with many calling for a 'Green Recovery' out of the pandemic. It would however be naive to consider this a sudden inclusion. There are now over 140 organizations worldwide that have adopted the four Principles for Sustainable Insurance as part of the United Nations Environment Programme initially launched in 2012, including insurers representing more than 25% of world insurance premium. More recently, Lloyd's of London made a range of commitments within its first ESG report in December 2020 including managing agents being asked to provide no new insurance cover in respect of thermal coal-fired power plants, thermal coal mines, oil sands or new Arctic energy exploration activities from 1 January 2022.

What does this mean for the FS and other industries?

From a regulatory perspective, if we continue to see an increase in scrutiny in relation to ESG related risks, insurers will need to factor this into their review. There is already evidence of large-scale costs for ESG matters such as the ongoing probe of DWS

ESG from a broker perspective

Group, occurring on three fronts across the SEC, BaFin in Germany and US Department of Justice, following allegations of overinflated ESG figures within their published annual report. The UK government has also announced its intention to make the disclosures recommended by the Taskforce on Climate-related Financial Disclosures mandatory by 2025. This will mean greater reporting and compliance by asset managers who fall within the FCA criteria – while this currently only applies to those with more than GBP5bn under management or under advice, a continued move toward sustainable practices and net-zero positions will undoubtedly incorporate a wider scope of companies in the foreseeable future.

While ESG is becoming more of a consideration, it does not yet form a mandatory part of an underwriting submission. However, insurers will assess the health of a company beyond quarterly or annual reporting to see whether it has the right values for investors in the longer term, including, its ability to reflect external societal values. This therefore incorporates the ability to meet the challenges of climate change. Many pertinent risk factors relate to company longevity such as potential for financial growth, capital adequacy and the existing balance sheet. It is therefore reasonable to expect ESG strategy will become a key underwriting factor in the future. For example, analysis of investment strategy and how sustainable this can be going forward. Insurers have already begun considering aspects such as long-term holdings where climate-related risks will materialise prior to maturity.

It is worth noting there is little ESG analysis that can be done on certain asset classes – investment-grade bonds and money-market funds, for instance – but there are obvious connotations for others such as commodity funds that invest in energy resources. ESG investment policy will also arguably become a virtue signalling tool for investors, who are not only looking to ensure their investments contribute to positive impact, but for ethical investment to remain a sustained focus in the global market. The recognition of the importance of ESG has been a slow process and the past 20 years has resulted in large asset managers

ESG from a broker perspective

becoming some of the world's biggest investors in carbon-intensive industries. What we are therefore seeing is a progressive shift towards a 'greener' classification of assets. With ESG integration moving from an optional to expected process, we are likely to see this accelerate in years to come.

At present, there is uncertainty as to how ESG will factor into an insurer's view of risk exposures. Will companies be penalised for inadequate ESG practices or rewarded for progressive policies as part of the company culture and investment strategy? Green finance initiatives have created a new ecosystem of compliance obligations, which can lead to significant liability exposures. New taxonomies of sustainability standards, as well as ESG-related shareholder activism, all must be skilfully navigated to avoid exposure. What can be said for certain is ESG is no longer about taking the 'right' approach; it is about creating a sustainable business model for the new economic environment.

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Environment

Digest:

- One of the most high-profile “biodiversity” announcements at COP26 was the Glasgow Leaders’ Declaration on Forest and Land Use.
- Signed by 133 of the world leaders, it committed to stop forest loss and land degradation.
- The commitments encompass finance as well as land tenure, forest rights and trade policies.

COP26 and the “forest promises”

Source/Context:

https://ukcop26.org/glasgow-leaders-declaration-on-forests-and-land-use/

Whilst there have been similar commitments to stop forest loss in the past, such as the New York Declaration on Forests in 2014, the COP26 announcement was more explicit in scope. Despite this, like many COP26 agreements, the wording contained an absence of specific definitions, such as an explanation on types of forests it referred to (whether natural forests only or whether it also encompasses plantations).

What does this mean for the FS and other industries?

There is some irony that countries’ use of green technologies will accelerate demand for minerals such as nickel which are often mined in forested areas; this conflict will difficult for services such as insurers who are investing in green technology to combat climate related risks.

The “forest promises” include an increase in finance and investment from a wide variety of “public and private sources, while also improving its effectiveness and accessibility, to enable sustainable agriculture, sustainable forest management, forest conservation and restoration, and support for Indigenous Peoples and local communities”. This is much broader than previous commitments, and those endorsing the commitment have control over more than 90% od the world’s forests.

With biodiversity increasingly on the agenda of ESG portfolios in the same way as climate change has been, the progress of this pledge is likely to be monitored closely over the next few years. When it comes to ESG considerations, firms may wish to take note of funds they are investing in which have a biodiversity pledge.

Environment

Digest:

- First COP to directly target the use of coal. 190 countries have agreed to end fossil fuel subsidies and the 'phasing down of coal power'
- It is likely that this is the start of a global focus on reducing energy generation through fossil fuels.
- With the decline of fossil fuels, new investment and insurance opportunities are going to be created in the renewables sector, which is likely to go through a period of rapid innovation

COP26 – and the battle against coal

Source/Context:

COP 26 was significant in that it directly targeted the use of coal, with 65 countries now committed to phasing out coal (20 more than pre-COP 26). All major coal financing countries have committed to end international co-financed by the end of 2021. 190 countries have agreed to end fossil fuel subsidies and the 'phasing down of coal power'.

What does this mean for the FS and other industries?

Using coal to generate electricity is still the single biggest contribution to greenhouse gas emissions (approximately 27%). Despite successful efforts in the UK over the last 10 years to remove coal from the energy generation mix, coal is still the primary method of electricity generation for many major countries.

It is widely accepted that to meet net zero targets countries are going to have to decarbonise their electricity supply. This means that the announcement targeting coal should not be viewed in isolation: similar action in future years is likely against all fossil fuels used in energy generation.

This change creates both opportunities and threats. Whilst businesses producing energy through coal (and those businesses that supply them) should see that part of their business start to rapidly decline, investment opportunities in renewable energy sources are likely to increase, as they are going to be needed to facilitate the move away from fossil fuels.

We have already seen an increase in technical innovation connected with renewable energy sources (for example deep geothermal at the Eden Project in Cornwall and floating wind turbines in the North Sea). This is only likely to increase as the global focus turns away from fossil fuels and towards renewable energy. This will lead to new investment opportunities but also new risk that will need insuring.

Social

Digest:

- The EBA has subtly reminded firms that sound remuneration policies should apply to *all* staff.
- "Investment firms should operate a gender neutral remuneration policy
- In addition to ensuring equal pay for the same position or positions of equal value, it is also necessary to ensure equal opportunities for all genders."
- Investment firms should be able to demonstrate that a gender pay gap does not result from a remuneration policy that is not gender-neutral.

Remuneration from a social perspective

Source/Context:

22 November, the EBA published their final report on Guidelines on sound remuneration policies under Directive (EU) 2019/2034 (the Investment Firm Directive or IFD).

What does this mean for the FS and other industries?

The report points to several aspects of remuneration policy that impact social factors such as gender-neutral remuneration, retention, and corporate culture and values.
Firms should be mindful that gender pay gap reporting may not be enough to warrant a high ESG score with respect to gender. The UK gender pay gap reporting requirements have long been criticised for 'having no teeth' and inadequate gender inclusion. The 'gender neutrality' approach from the EBA may reflect a more diverse approach. They also address the concept of 'equity', noting that the principles of equal treatment should not prevent the adoption of measures providing advantages for underrepresented genders.

The report also addresses 'retention policy'. This topic typically focuses on ensuring bonuses to retain senior managers do not limit the firm's ability to strengthen its capital. However, retention presents a much broader issue, particularly for racialised staff. A report on racial equality in the UK financial services sector found that (48%) of ethnic minority respondents "believe their career progression is slower than that of their white colleagues". In addition, only 3 of 19 financial services companies in the FTSE 100 voluntarily report their ethnicity pay gap.

In their discussion paper, the FCA has made clear that they want firms to think about advancing diversity and inclusion via their remuneration arrangements and have suggested monitoring retention data, accounting for voluntary and involuntary departures by diversity characteristics. With this in mind, firms should prepare themselves by looking at the broader implications of their remuneration policies.

Governance

Digest:

- Large EU companies are required to disclose annually non-financial information.
- The European Commission has proposed a Corporate Sustainability Reporting Directive (CSRD) which expands the requirement to publish non-financial information – now to be known as sustainability information – to a much larger group of companies, establishes more detailed, mandatory disclosure rules and strengthens the role of auditors to ensure dependable disclosures
- At the end of 2020, the Commission proposed a Sustainable Corporate Governance Initiative (SCGI) that would complement the provisions of the CSRD by introducing duties to act, rather than only to report.

ESG compliance and regulation – going beyond corporate reporting

Source/Context:

ESMA speech 19.11.21 on “ESG – Next Level Reporting ..."

The European Securities and Markets Authority (ESMA) is an independent European Union (EU) Authority that assesses risks to investors, markets and financial stability.

ESMA has noted that the CSRD does not entail an actual obligation to carry out ESG due diligence, and “the [SCGI] aims at bringing consistency in the way companies address corporate governance issues in practice and hold them fully accountable for how they mitigate their adverse environmental and social impacts.”

What does this mean for the FS and other industries?

ESAM is aiming “to find the appropriate mechanisms to make sure that [securities] issuers and their directors take into account a broader set of stakeholder interests in their corporate decisions [than] ... is currently the case ... [This] would ... contribute to a more robust identification of potential sustainability risks ... and ... would generally facilitate ... more long-term oriented decisions ... Another important aspect where improvements are needed is the scope of due diligence requirements on supply chains ...”

The SCGI aims “to curb greenwashing and enhance the reliability of the ESG information that is disclosed to the market by ensuring that reporting obligations are paired with adequate corporate and director duties ...”

Governance

Digest:

- An insurer's culture may be viewed through a variety of lenses to understand whether it appears healthy, sustainable, purposeful and safe.
- A strategic review in 2017-2018 highlighted that conduct and culture are of increasing importance to both conduct and prudential supervisors. This has been further reinforced in light of the Covid-19 pandemic.
- Insurers and regulators need to understand whether and how a culture effectively promotes safety and soundness, the interests of policyholders, and the fair treatment of customers.

Insurer culture, and prudential and conduct risks

Source/Context:

Issues Paper on Insurer Culture

The International Association of Insurance Supervisors (IAIS) is a voluntary organisation from over 200 jurisdictions. Its mission is to promote effective and globally consistent supervision for fair, safe and stable insurance markets that benefit and protect policyholders and global financial stability.

The report is light on specific examples, but gives prominence to the US Congress inquiry into Wells Fargo.

What does this mean for the FS and other industries?

The IAIS recognises the need for holistic, thorough and continuous assessment:

"[D]ifferent cultures may exist within ... [an insurer] ... Assessing how behaviours and practices filter through the different [operational] structures, management and staff levels ... as well as across its various functional areas, and geographical locations ... may provide better understanding of the depth and consistency of cultural embedment ..."

"Identifying shortcomings in ... culture may prove less challenging than actually correcting them, which will require [the insurer's] long-term commitment ..."

"Supervisory assessments of culture often ... focus on the tone set by the Board and Senior Management. However, decision-making and behaviours [of] middle and lower [management] ... are critical to evaluating ... cultural tone ..."

Governance

Digest:

In order to use a 'Sustainable' or 'Responsible' product label, firms may need to demonstrate attributes such as:

- Meeting existing governance, systems and controls requirements;
- Identifying how ESG considerations are integrated into investment processes to minimise risks and take advantage of opportunities;
- Stewardship and using ownership rights (eg voting and engagement).

Sustainability labelling

Source/Context:

DP21/4: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)

The FCA is consulting on the labelling for investment products which firms intend to market as ESG sustainable or responsible.

What does this mean for the FS and other industries?

Assertions of 'sustainability' will be assessed against the following gradations:

a) 'Impact': Products with the objective of delivering net positive social and/or environmental impact alongside a financial return.

Minimum criteria: Intentionality, theoretical ability to deliver and measure additionality through investment decision-making and investor stewardship, impact measurement and verification.

b) 'Aligned': Products with sustainability characteristics, themes or objectives and a high proportion of underlying assets (measured according to a minimum threshold) that meet the sustainability criteria set out in the UK Taxonomy or could otherwise be verifiably established as sustainable.

Minimum criteria: See Transitioning criteria below, with the addition of minimum thresholds for asset allocation.

c) 'Transitioning': Products with sustainability characteristics, themes or objectives that do not yet have a high proportion of underlying assets meeting the above sustainability criteria, but pursue strategies that aim to influence underlying assets towards meeting sustainability criteria over time, for instance through active and targeted investor stewardship.

The expectation, therefore, is that this proportion will rise over time.

Additional matters

Further analysis, resources and events

ESG for beginners

Netting zero' # 1

"All Round ESG-ellence - Developing an effective ESG Sustainability and Responsibility Programme #1: The fundamentals

Greenwashing (manifestation and prevention): Part 1: Manifestation: 'How green is your wash?'

Greenwashing (manifestation & prevention): 'How green is your wash?' part 2: The genesis of 'ESG Compliance'

Culture, Conduct and Covid-19: Survey Report 2021

RECCE (reflect, evaluate, cohere, communicate, evolve) - Culture, Conduct and Covid report

The difficulties with a 'business case' for Equality, Diversity and Inclusion ("EDI") in the financial services workplace

"Good insurance business: can insurers save the world?"

Other useful information:

Events

Useful Links

Financial services | Browne Jacobson LLP

Other news…

A summary of other ESG related news events

[Joint statement by the FCA, PRA, TPR and FRC on the publication of Climate Change Adaptation Reports]	The FCA are focused on making sure that the risks from climate change and the opportunities from the transition to a net-zero economy are being identified and proactively managed across the financial sector. Doing so creates opportunities for UK companies and consumers, as well as helping address climate change. The FCA welcomes the Government's invitation under the Climate Change Act 2008 to publish Climate Change Adaptation Reports. The FCA reports set out how climate change affects our respective responsibilities and the actions we, and the financial sector, are taking in response to it.
[FCA acts to help investors make more informed ESG investment decisions]	The FCA is committed to helping investors put environmental, social and governance (ESG) matters at the heart of their investment decisions.
[The Politics of ESG: what financial institutions need to know]	Financial institutions face environmental, social and governmental (ESG) aspects of global governmental policies as a result of COP26. This article covers corporate citizenship, enhanced state intervention, the rise of populism, the intensifying focus on the "S" and "G", the new green hubs versus the issue of developing countries, the lack of international regulatory harmonization and human rights compliance obligations.
[Bank of England sets plan to tilt asset purchases toward green companies]	The UK's central bank will this month begin prioritising bond issuers judged to be "stronger climate performers" via its £20 billion ($27 billion) corporate bond purchase scheme, in a landmark move that warns climate laggards will be hit with higher cost of capital.
[IAIS issues statement on the importance of DE&I considerations in insurance supervision]	There is growing acknowledgment that advancing DE&I within insurers' organisations and business models supports sound prudential and consumer outcomes and sustainability objectives. DE&I also touches on several strategic themes identified in the IAIS Strategic Plan 2020-2024. It is particularly relevant to conduct and culture, but also to financial inclusion and sustainable economic development as well as technological innovation.

Meet the team

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