CDP Report: Financial Institutions Face Challenges in Addressing Nature-Related Risks

October 3, 2023

By Jason Halper
Partner and Co-Chair | Global Litigation

By Sara Bussiere
Special Counsel | Global Litigation

In a report published in August 2023, non-profit disclosure organization **CDP concluded** that financial institutions often are not accounting for nature-related risks and opportunities in their "financial decision-making," and it urged these organizations to recognize the link between the impacts on climate and nature. In **"Nature in Green Finance: Bridging the gap in environmental reporting,"** CDP states: "While climate change is now widely considered within financial institutions' strategies, disclosure and action on forests, water, and broader nature-related issues lag significantly behind," although "several trends indicate a gradual shift in financial institutions moving beyond tackling climate change in isolation, to addressing nature in tandem."

According to CDP, nearly 95% of the 556 banks, insurers and asset owners surveyed reported that climate change influences their business strategies or financial planning. However, less than a third responded that forest issues and water security have an impact on their financial strategies. Currently, only 10% of the financial institutions surveyed measure their portfolio impact on forests and water, although an additional 30% plan to start doing so in the next two years. In the report, the CDP acknowledged that meaningful target setting, a key part of transitioning to net zero, continues to be a significant challenge for most financial institutions. Only 29% of those surveyed have set portfolio targets for climate change. Notably, while just one in 10 financial institutions have metrics in place to measure their portfolio impact on forests and water, 23% of the banks surveyed have begun including forest-related covenants in financing agreements and 21% include covenants related to water.

The CDP attributes a lack of governance mechanisms and board-level expertise for its findings. According to CDP, "26-28% of boards have business strategies or financial planning influenced by nature-related risks and opportunities," while "board oversight and assessments of nature-related risk exposures rise to 51% and 45-47% when including those financial institutions that intend to address these issues within the next two years." CDP further reports that "91% of FIs reporting to CDP have board-level oversight of climate-related issues, compared to 32% with oversight of forests and/or water-related issues. Even fewer FIs have at least one board member with competence on climate (68%) and/or nature-related issues (24%), underscoring the need to enhance board-level competence on environmental issues as a whole."

Although an increasing number of financial institutions are identifying greater climate and nature-related opportunities compared to risks, less than 30% are capitalizing on these opportunities to provide green financing solutions that support businesses in mitigating deforestation and water-related impacts.

Taking the Temperature: Biodiversity and habitat preservation is a growing area of focus. In December 2022, nearly 200 countries at the United Nations Biodiversity Conference (COP15) adopted the Global Biodiversity Framework (GBF), agreeing to protect at least 30% of the planet's lands, inland waters, coastal areas and oceans by 2030 (known as the "30x30" target). The GBF centers nature and biodiversity as a key part of the discussion around financial institutions' climate change goals. As the CDP report points out, "with the World Economic Forum estimating that US$44 trillion of economic value generation - over half of the world's total GDP - is moderately or highly dependent on nature and its services, nature-related risks and opportunities" can be materially significant for financial institutions. As the report also points out, there is significant guidance on nature-related reporting, with, for instance, the Task Force on Nature Related Disclosure (TFND) just recently having published its final recommendations for voluntary nature-related disclosures. The TFND recommends 14 disclosures to "promote the provision of clear, comparable and consistent information by companies to investors and other providers of capital. The Taskforce provides a set of metrics for measurement and a suite of guidance to help organizations get started on nature-related assessment and disclosure."

CDP is hardly the first organization to focus on biodiversity strategy, financing and reporting. Regulators have urged financial institutions to assess nature-related climate change impacts as another aspect of risk to financial stability; in March this year the EU announced its carbon sinks initiative. The UK launched an inquiry into directing capital towards nature recovery and earlier this year, announced jointly with France, that the two countries had developed a roadmap to boost the biodiversity credits market. And, the United Nations announced the formation of a 35-member bank-led working group to promote nature- and biodiversity-related target setting that is aligned with the Kunming-Montreal GBF adopted at COP15 last year, as well as to implement other climate-related market standards such as the recommendations of the TFND. At the same time, significant challenges remain, including those highlighted in the CDP report as well as, for instance, continuing illegal deforestation, and questions surrounding the sources of capital to fund nature-related conservation efforts.

S&P to Apply Modeling to Address Missing Company Disclosures For ESG Ratings

October 3, 2023

By Simon Walsh
Special Counsel | Global Litigation

By Timbre Shriver
Associate | Global Litigation

In August 2023, S&P Global announced that it would be changing its approach to its ESG Scores on corporate sustainability performance, citing inconsistent company disclosures. The **"S&P Global ESG Scores Methodology"** is an industry-specific relative score (on a scale of zero to 100) designed to measure a company's performance and management around ESG-related risks, opportunities and impacts.

The primary source of information underlying the Global ESG Scores is S&P Global's Corporate Sustainability Assessment (CSA), which evaluates the sustainability practices of more than 13,000 companies in 62 industries worldwide using industry-specific questionnaires. Participating companies complete the annual CSA by providing data and supporting evidence, including internal documentation. More than 3,000 firms participated in the 2022 CSA.

Before the recent change in methodology, to assess companies that did not participate in the CSA, S&P itself completed the CSA questionnaire using publicly available information, assigning the minimum possible value of zero to questions where the relevant data was not publicly available. Noting limitations associated with this approach, S&P developed modeling designed to emulate the performance-based scoring that could have been applied if reported data were available, although modeling cannot be applied to the more than 40% of the CSA questions that require companies to disclose information publicly in order to score any points.

Taking the Temperature: As S&P notes in its statement announcing the changes to its methodology, sustainability metrics are increasingly a focus for both industry and investors, and more companies are willing (and able) to provide ESG-related information (as evidenced by the more than 3,000 companies that participated in the most recent CSA). As a result, there continues to be a proliferation of ratings providers. However, there is continuing concern that ESG ratings providers are not consistent in the methodologies that they apply and as a result, the ratings are potentially misleading for investors, as we have highlighted.

Regulators also have taken notice. The UK's financial regulator, the Financial Conduct Authority (FCA), is evaluating the ESG ratings market with a view to bringing ratings within its regulatory purview. The FCA also published a draft code of conduct for ESG

ratings providers earlier this year. Also earlier this year, the European Commission adopted a proposed regulation, which was based on 2021 recommendations from the International Organization of Securities Commissioners, aimed at promoting operational integrity and increased transparency in the ESG ratings market through organizational principles and clear rules addressing conflicts of interest. Ratings providers would be authorized and supervised by the European Securities and Markets Authority. The regulation "provides requirements on disclosures around" ratings methodologies and objectives, and "introduces principle-based organizational requirements on" the activities of ratings providers. In July 2023, the Securities and Exchange Board of India formalized regulations governing ESG ratings providers, as we discussed in connection with its consultation on the issue.

A key consideration for ratings is consistency. For example, in May this year, MSCI also announced a change to its ESG Rating Methodology, which resulted in downgrades to 31,000 of the funds rated by MSCI. Methodological changes that have such significant impacts on ratings are likely to amplify calls for regulation, particularly as ratings methodologies remain unclear, the sources of information supporting scores varies, and scores diverge among different providers.

COP28 UAE Presidency Announces Water Agenda

October 3, 2023

By Duncan Grieve
Special Counsel | White Collar Defense and Investigations

On August 24, 2023, at World Water Week in Stockholm, **the COP28 UAE Presidency announced** its Water Agenda ahead of COP28, formally known as the 2023 United Nations Climate Change Conference, to be held between November 30 and December 12, 2023, in Dubai. The delegation's three priorities will be conserving and restoring freshwater ecosystems, enhancing urban water resilience and bolstering water-resilient food systems.

The COP28 UAE Presidency also unveiled a partnership with the Netherlands and Tajikistan, which will serve as COP28 Water Champions, to deliver water policy, technology and financing results at COP28. The two countries co-hosted the UN 2023 Water Conference in March, which led to the formulation of the **Water Action Agenda**.

In addition, COP28's two-week program will feature Food, Agriculture and Water Day, during which the UAE and Brazil will co-host the first UNFCCC high-level dialogue on building water resilience in food systems. At this event, representatives from the government, private sectors and international organizations will assess water and food resilience within National Determined Contributions (NDCs) and National Action Plans (NAPs). Participants will focus on innovation investment, regenerative agriculture and national transformation pathways, underpinned by financing mechanisms.

"With the COP28 Water Agenda, in collaboration with the Netherlands and Tajikistan, we seek to bridge the insights from the UN Water Conference with the climate community, amplifying our adaptation and mitigation efforts," said Zavqi Zavqizoda, the Tajik Minister of Economic Development and Trade.

Taking the Temperature: There has been controversy surrounding the decision to have the UAE host COP28 and to name Sultan al-Jaber, the CEO of Abu Dhabi National Oil Co, as COP28 President given that it is one of the world's largest oil and gas producers. In May 2023, 133 U.S. and EU politicians called for the removal of Al-Jaber from the COP28 Presidency.

COP28 will be the second COP that includes water on its official agenda. The second week of COP27 last year in Egypt focused on the link between water and global warming, and launched water-related initiatives, including the Action on Water Adaptation and Resilience (AWARe). AWARe aims to decrease water losses worldwide and improve water supply, and promote cooperation and linkages between water and climate action.

By continuing to prioritize the water agenda, COP28 will increase awareness of international water-related risks and opportunities in areas that have not received as

much coordinated attention, such as agriculture. Policies to improve water quality, for example, have been adopted on a regional basis, such as the European Parliament's proposed legislative amendments we reported on in June to reduce pollution in Europe's water bodies covering inland, transitional and coastal surface waters and groundwater.

Support for Climate-Related Shareholder Resolutions Declines During 2023 Proxy Season

October 3, 2023

By Jason Halper
Partner and Co-Chair | Global Litigation

By Sharon Takhar
Associate | White Collar Defense and Investigations

In August 2023, following this year's proxy voting season, two of the world's largest asset managers published their voting records, which revealed that their support for environmental and social shareholder resolutions had declined. The asset managers attributed this decrease to the poor quality or unduly restrictive nature of resolutions put forward.

In a **summary report**, BlackRock reported supporting 7% of a total of 399 environmental and social resolutions, compared with 22% in the previous proxy period. The asset manager also reported that while such proposals addressed relevant issues, they often "sought simplistic outcomes that overlooked the competing priorities companies were balancing and the complexity and interconnected nature of the issues." Blackrock described the shareholder proposals as overly prescriptive, thereby unduly constraining on management decision-making.

Similarly, in its **U.S. Regional Brief**, Vanguard reported that it saw a higher proportion of environmental and social proposals put forward – 359 compared to 290 in 2022 – and that votes in support amounted to just 2%, compared to 12% in 2022. Vanguard attributed the contrast in figures in part due to the nature and volume of proposals and in part to changes in SEC guidance. Rule 14a-8 of the Securities Exchange Act of 1934 previously allowed a company to exclude a stockholder proposal that "deals with a matter relating to the company's ordinary business operations." Previously under this exception, companies could exclude proposals concerning social policy issues if the proposal was not material to the company's business. However, recent SEC guidance instructed issuers that proposals regarding significant social issues should be included in company proxy materials even absent a nexus between the social policy issue and the company's business. Now, the SEC will "consider whether the proposal raises issues with a broad societal impact, such that they transcend the ordinary business of the company."

Earlier in the year, State Street Global Advisers published its voting record, having supported **32% of environmental and social proposals in Q1 2023** compared to **44% in the same period in 2022**.

Taking the Temperature: While the SEC's amendments to Rule 14a-8 allowed for an increase in the volume of environmental and social shareholder proposals, according to

Vanguard and Blackrock, it also contributed to a decline in quality. For example, Vanguard described that at the end of April 2023, at the annual meeting of Starbucks Corporation, Vanguard-advised funds evaluated but elected not to support a shareholder proposal requesting a third-party assessment of the company's unionization policies. Although Vanguard considers workers' rights to be a material risk for Starbucks, Vanguard did not vote to support it because, in Vanguard's view, the company had already been taking effective action through, for example, its commitment to engage third parties to undertake a human rights impact assessment, which covered workers' rights. Vanguard also expressed its view that the board was taking appropriate action on the issue proposed.

When assessing the decline in these asset managers' support for ESG-related shareholder proposals, it is difficult to ignore the political backdrop in the U.S., a topic we frequently discuss. In 2022, a number of U.S. states threatened to withdraw funds from BlackRock in response to what one state treasurer referred to as "globalist, leftist ideas." In January this year, Kentucky's Treasurer included BlackRock on a list of eleven financial institutions that she claimed were engaged in "energy company boycotts" as a result of their investment policies related to sustainability. Ultimately, BlackRock's CEO said that he had stopped using the acronym "ESG" as it had been weaponized by political figures on both sides of the ESG discussion. We also discussed that, at the end of last year, Vanguard withdrew from the Net Zero Asset Managers initiative following a report by the Minority Staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs regarding the influence of the "liberal views" toward ESG of the "Big Three" asset managers, Blackrock, State Street and Vanguard. On the other hand, more than 1,400 individual investors signed a letter asserting that Vanguard is violating its fiduciary duty to mitigate climate-related investment risks by, among other things, not being more active in casting proxies consistent with its climate expectations and due to Vanguard's withdrawal from the NZAM. Perhaps in part to avoid this "tails-I-lose-heads-you-win" dynamic, Blackrock, Vanguard and other large asset managers are piloting programs allowing investors to have greater say in how their shares are voted on ESG and other proposals.

ESMA Launches Fifth Stress Test Exercise for Central Counterparties That Includes Climate-Related Risks

October 3, 2023

By Sukhvir Basran
Partner | Financial Services

By Ludovica Veltri
Associate | Securitization & Asset Based Finance

On May 31, 2023, the European Securities and Markets Authority (ESMA) **published a final report** on the framework for the 5th ESMA Stress Test Exercise for Central Counterparties (CCPs). For the first time, climate risk has been included among the components of the test. In part, the inclusion of climate risk in the Stress Test evidences the regulator's interest in evaluating the impact that the energy crisis and market disruption following the COVID-19 pandemic have had on CCPs, and how CCPs have responded to such events.

ESMA has been running such Stress Tests since 2016, and they represent part of its strategy to assess and evaluate the resilience of CCPs, which form a core element of the financial system in the EU, providing stability and mitigating financial risks. ESMA describes the Stress Tests as a key tool to strengthen the flexibility and resilience of the CCPs, in order to enhance and ensure the stability and effectiveness of the EU capital markets.

ESMA's goal is to obtain an overview on how prepared CCPs are to tackle climate risks. For the 2023 Stress Test, fourteen CCPs authorized in the EU and two authorized in the UK are included in the exercise. The main components of the Stress Test are: (i) credit stress; (ii) concentration risk; (iii) liquidity stress; (iv) reverse stress; and (v) climate risk.

In order to assess CCPs' response to climate risks challenges, the scenario presented in the Stress Test features, among other things, the transition to a carbon-neutral economy and the consequences of such transition. The study of the CCPs' business models and their reaction to such changes will be carried out taking into account the long-term pillars of climate risk: (i) business model risk, i.e., the risk to the profitability and stability of a CCPs' business model; (ii) physical risk, i.e., the risk that an extreme weather event could have on the CCPs and its ecosystem, with consequences such as operational disruptions and market instability; and (iii) collateral replacement risk, i.e., the risk that market participants might eventually need to replace assets provided as collateral following a negative evaluation of the eligibility of such assets.

Taking the Temperature: The decision by ESMA to include climate risk among the components of the Stress Test evidences how EU regulators are adapting their approach to the evaluation of resilience of CCPs to increasing climate challenges. In doing so, as

also remarked by Verena Ross, Chair of ESMA, in an interview, the additional innovative approach adopted by ESMA was that of assessing how climate risk can impact CCPs as a whole, rather than analyzing them individually, and to show how the various CCPs are interconnected.