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## COP28 Update: Agreement Reached on Loss and Damage Fund

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On November 30, 2023, the first day of COP28, nearly 190 countries finalized the terms for the framework of a loss and damage fund to assist developing countries to respond to harms caused by climate change. The fund was **first announced** at COP27 last year, along with the formation of a **“transitional committee”** to make recommendations on how to operationalize the funding arrangements. Over the last year, there has been much debate as to how the fund should work—i.e., who should fund it and how the fund should be allocated.

A draft of the framework is provided [here](#). Recognizing that “climate change is a common concern of humankind,” the fund’s purpose is to “assist developing countries that are particularly vulnerable to the adverse effects of climate change in responding to the economic and non-economic loss and damage associated with the adverse effects of climate change, including extreme weather events and slow-onset events.” The fund will provide funding for “economic and non-economic loss and damage associated with the adverse effects of climate change.” The fund may provide support for both short-term and long-term actions, as well as actions to address slow onset events. Examples of such funding include “the development of national response plans; addressing insufficient climate information and data, and promoting equitable, safe and dignified human mobility in the form of displacement, relocation, and migration, in cases of temporary and permanent loss and damage.”

The World Bank will manage the fund for four years, beginning in 2024. Importantly, funds will be voluntarily committed and directed to those “particularly vulnerable” to damage from climate change, and all developing countries will have access to the fund.

The fund will be governed and supervised by a board with “responsibility for setting the strategic direction, governance and operational modalities, policies, frameworks and work progra[m], including relevant funding decisions.” The Board will have 26 members, with 12 members from developed countries; three members from the Asia-Pacific States; three members from the African States; three members from the Latin American and the Caribbean States; two members from small island developing States; two members from the least developed countries; and one member from another developing country not previously included.

When making decisions, the Board is charged with considering the following:

- The priorities and needs of developing countries that are particularly vulnerable to the adverse effects of climate change, while taking into consideration the needs of climate-vulnerable communities;

- Considerations of the scale of impacts of particular climate events relative to the national circumstances, including but not limited to, response capacities of the impacted countries;
- The need to safeguard against the overconcentration of support provided by the Fund in any given country, group of countries or region;
- The best available data and information from entities such as the Intergovernmental Panel on Climate Change, and/or pertinent knowledge from Indigenous Peoples and vulnerable communities on exposure and sensitivity to the adverse effects of climate change and on loss and damage, recognizing that such data, information or knowledge may be limited for specific countries and regions;
- Estimates of recovery and reconstruction costs based on data and information from relevant entities, in particular from national and/or regional entities, recognizing that such data or information may be limited for specific countries and regions; and
- A minimum percentage allocation floor for LDCs [least developed countries] and SIDS [small island developing states].

**Initial contributions** to the fund were announced at COP28, including \$100 million committed by each of the UAE and Germany, £40 million pledged by the UK for the fund and £20 million for other arrangements, \$10 million contributed by Japan, and \$17.5 million from the U.S.

**Taking the Temperature: The announcement of the loss and damage fund framework was one of the key points in UAE President Dr. Sultan Al Jaber’s opening remarks at COP28, which lauded the agreement as “historic.” Though the announcement garnered considerable attention, the initial financial commitments from developed countries following the announcement fell well below the estimated amount needed on an annual basis. In addition, the current framework does not have any plan for replenishing the fund in the future. Therefore, the devil will be in the details as the fund continues to take shape, Board members are appointed, and actual action is taken to mobilize the goals of the fund.**

# European Banking Authority Reports on the Role of Environmental and Social Risks in the Prudential Framework

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**By Rachel Rodman**

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In October 2023, the European Banking Authority (EBA) **published a report** addressing the need for a comprehensive prudential framework that adequately considers emerging environmental and social risks. The report is a response to Article 501c of Regulation (EU) No 575/2013 (the Capital Requirements Regulation 2013 (CRR)) and Article 34 of Regulation (EU) 2019/2033 (the Investment Firms Regulation (IFR)), and the EBA initiated its publication through a discussion paper on May 2, 2022. This report signals a series of upcoming reports in line with the CRR.

To address environmental and social risks, the report advocates a holistic approach, suggesting short-term enhancements to the current Basel Pillar 1 framework. These modifications aim to swiftly integrate environmental and social risks, emphasizing risk management/supervision (Pillar 2) and market transparency (Pillar 3). The proposed changes cover both standardized and idiosyncratic approaches, recognizing the efficacy of internal models in capturing new risks. Pillar 1, 2 and 3 requirements were established by Basel II. Pillar 1 establishes minimum capital requirements based on market, credit and operational risks, including environmental risks, and a minimum leverage ratio. Pillar 2 applies in addition to Pillar 1, where this underestimates certain risks. Pillar 3 focuses on transparency through prescribed public disclosures.

Recognizing the link between environmental and social factors and traditional financial risks, the report emphasizes institutions' need to develop techniques for identifying and quantifying these risks. The EBA plans to monitor the incorporation of environment-related information into models and accounting, proposing amendments to supervisory reporting frameworks for enhanced data collection on environmental risks.

Considering data challenges, the EBA explores scenario analysis to enhance the forward-looking elements of the prudential framework. The report acknowledges ongoing developments in the sustainable finance regulatory framework, highlighting the need for future prudential treatments to align with emerging policy tools.

**Taking the Temperature: [We reported in December 2022](#) on the EBA's publication of its roadmap on sustainable finance, which outlined the "objectives and timeline for delivering mandates and tasks in the area of sustainable finance and environmental, social and governance (ESG) risks." The roadmap set out the EBA's plan for the next three years to "integrate ESG risks considerations" into the banking framework and to "support the EU's efforts to achieve the transition to a more sustainable economy." The**

roadmap followed various legislative acts and initiatives that have allocated to the EBA “new mandates and tasks in the area of sustainable finance and ESG risks.”

As elements of the European sustainable finance regulatory framework are still evolving, the EBA is set to continue integrating environmental and social risks across all regulatory pillars. This aligns with broader initiatives outside of the prudential framework that aim to contribute to the transition towards a sustainable economy while ensuring the resilience of the banking sector. [As we previously reported](#) on June 1, 2023, the EBA articulated a common, high-level definition of greenwashing and outlined greenwashing risks, impacts, proposed mitigation efforts and challenges for the industry. [We also reported](#) on the EBA’s release of its opinion on the first set of European Sustainability Reporting Standards, in which the EBA stated that the ESRS promoted “significant improvement” in climate-related disclosures and demonstrated “overall consistency with international standards and relevant EU Law.” Notably, the EBA recognized how the ESRS “better align[ed] with the disclosure requirements under [the] EBA’s Pillar 3 Framework.”

# UK Government Taskforce to Produce Guidance for Pensions Sector to Consider Social Factors in Investment Decisions

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**By Sharon Takhar**

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On October 19, 2023, the UK government's Taskforce on Social Factors (Taskforce) launched a consultation to produce guidance on how pension funds can consider social issues in their investment decisions. The guide is intended to help occupational pension schemes to identify and monitor the broader social impact and implications of their investment activities. Social factors subject to consideration in the guidance will include workforce conditions and supply chains, community engagement, consumer protection and modern slavery. The Taskforce was formed in February 2023 by the Department for Work and Pensions (DWP) and its members include representatives from pension schemes, asset managers, data providers, cross-industry collaboration groups and civil society.

The draft guidance that is the subject of the consultation contains 30 recommendations across three sections:

1. **Social factors and pension funds**, which sets out why material social factors are important from an investment perspective and how taking these into consideration aligns with trustees' fiduciary duties.
2. **Social factor data**, which discusses the data that trustees can use to manage social factors in investment decision making, along with a materiality assessment framework to help prioritize areas for action.
3. **Addressing social factors in pension portfolios**, which "sets out a framework for addressing social factors in pension schemes, providing baseline, good and leading practice indicators, with a deep dive into the issue of modern slavery and how trustees can approach this social factor in their investments."

The consultation closed for feedback on December 1. The Taskforce aims to issue an official guide in 2024 for UK pension scheme trustees.

**Taking the Temperature:** This consultation highlights the fact that UK pension funds are under scrutiny for both the environmental and social impact of their activities. Earlier this year, the UK Pensions Regulator (TPR) conducted a review of the published annual climate reports of more than 71 UK pensions schemes. The review found several areas for improvement, as well as some [emerging good practices](#). It is hoped that a sector-specific guide outlining how trustees can consider social factors in their investment decisions will be a helpful enhancement to such reporting, in addition to providing cohesion both within and across specific sectors.

**We also reported** on an article published by TPR’s Executive Director, Mark Hill, in which he set out how pension fund trustees can improve the climate-scenario analyses they use in order to make them more “decision-useful.” The UK pensions sector was in the spotlight earlier this year when Border to Coast Pension Partnership, a pension pool consisting of 11 UK local government pension schemes, **announced that** “[o]il majors and banks must make greater progress on climate pledges or risk losing the support of Border to Coast Pensions Partnership on key votes this” Annual General Meeting season. **Similar pressure** was also exerted by New York City pension funds.

In the U.S., the appropriateness of consideration of ESG issues in investment decision making remains subject to debate. In August, American Airlines asked a court to dismiss a **class action lawsuit** filed against it by a current employee, who alleged that the airline’s ESG investment strategy jeopardized employees’ retirement savings by investing in ESG funds managed by BlackRock and other asset managers. **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. That said, **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**.

## Toolkit in Progress on Deforestation and Land Conversion-Linked Financial Crimes

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**By Duncan Grieve**

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On October 17, 2023, Themis, a technology platform that helps its clients manage their financial crime risk exposure, and World Wildlife Fund (WWF) UK, announced that they are working together to produce a Deforestation and Land Conversion-Linked Financial Crimes Toolkit to be launched next year.

As the statement announcing the [toolkit](#) explains, deforestation, in particular of tropical forests and ecosystems in the Amazon, the Congo Basin and Southeast Asia, and land conversion, when land is converted from its primary use, such as a forest, savannah or grassland, for agriculture or infrastructure uses, have significant environmental impact globally. Earlier this year, the Grantham Research Institute on Climate Change and the Environment at the London School of Economics [estimated](#) that land use change and, in particular, deforestation, may contribute up to 20% of global greenhouse emissions. Forest degradation—in which total forest area remains unchanged but its structure or overall function has been altered—is also problematic. Both deforestation and land conversion can also adversely impact disenfranchised indigenous and local communities more acutely, causing health issues, loss of income, displacement and human rights violations.

As the statement notes, while deforestation and land conversion are often driven by demand for legal, high-value cash crops, including everyday consumables like cocoa, coffee and cattle, as well as resources such as timber, rubber and minerals, the production of these commodities are also susceptible to infiltration by criminal groups. Government corruption, inadequate land protection regulations, or limited regulatory oversight can lead to illegal land conversion, exposing financial institutions in certain regions to the risk of financial crimes related to these commodities. The Toolkit on Deforestation and Land Conversion-Linked Financial Crimes aims to help financial institutions understand and identify these risks, and address and report any transactions that may involve illegal deforestation and land conversion to the authorities.

The Deforestation and Land Conversion Toolkit will be modeled on the [Illegal Wildlife Trade \(IWT\) Toolkit](#), also produced by Themis and WWF, and will include guidance on a strategic framework and best practices, risk assessment and reporting, as well as general subject matter background. Both toolkits aim to offer a broad view of direct and indirect risks across supply chains.

The first stage of the project is led by UK Finance, a trade association that represents over 300 firms across the UK banking and financial services sector, which is finalizing a research report on deforestation and financial crimes to be shared at COP28 in Dubai. The report will be based on a survey from professionals at financial institutions, in particular, risk and compliance



professionals in banks and insurance firms. The finalized deforestation toolkit will be launched at COP29, set to take place in Q3 2024.

**Taking the Temperature:** While deforestation and land conversion have long been the topic of environmental and social activism, the legal and financial risks associated with directly or indirectly financing or otherwise causing deforestation, whether legal or illegal, are rapidly growing in significance. As we have reported recently, deforestation is increasingly the focus of regulatory, litigation and environmental advocacy attention globally. In June, [Brazil announced a package of environmental measures](#) aimed at controlling and eventually halting deforestation by 2030. Outside of this high-risk region and others, regulators are focused on the impact that the industry has on deforestation and environmental degradation. In April, the U.S. Department of Justice formed the [Timber Interdiction Membership Board and Enforcement Resource \(TIMBER\) Working Group](#) to investigate and prosecute the illegal trade of timber around the world and the deforestation that results. [And as we covered in June](#), the European Parliament has adopted amendments to the Corporate Sustainability Due Diligence Regulation requiring large companies operating in the EU to conduct due diligence to identify, prevent, mitigate or end negative impacts on human rights and the environment, including biodiversity loss and environmental degradation. Industry's role in deforestation has also resulted in litigation. In May, environmental group ClientEarth filed a complaint against Cargill, one of the world's largest soy and grain traders with the Organization for Economic Cooperation and Development (OECD) over [alleged deforestation and related human rights issues](#) in Brazil in violation of the OECD Guidelines for Multinational Enterprises. [We also reported](#) earlier this year on a novel arbitration strategy on the part of Azerbaijan, which commenced an action against Armenia under the Bern Convention on the Conservation of European Wildlife and Natural Habitats, the first such interstate arbitration alleging that actions including deforestation have jeopardized more than 500 wildlife species.

# ICMA Working Group to Develop Voluntary Code of Conduct for Hong Kong ESG Ratings

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**By Timbre Shriver**  
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On October 31, 2023, the **International Capital Market Association (ICMA)** announced that it would be forming a working group to develop a voluntary code of conduct for Hong Kong-based ESG ratings and data providers. ICMA will coordinate with asset managers and working group members, including Bloomberg and Fidelity International, to establish best practices.

With the object of global interoperability, the code's development will be based upon International Organization of Securities Commissions' (IOSCO) recommendations, especially across four key areas: transparency, governance, conflicts of interest, and systems and controls. This project is sponsored by the Hong Kong Securities and Futures Commission (HK SFC), which will observe the working group's progress along with the Hong Kong Monetary Authority.

Julia Leung, CEO of HK FSC, **expressed hope** that Hong Kong's voluntary code of conduct would "strengthen the transparency, quality and reliability of ESG information used by licensed corporations in their investment decisions." The end product is intended to streamline asset managers' due diligence process on ESG service providers.

**Taking the Temperature: As we discussed last year, but still holds true today, there is continuing concern that ESG ratings providers are not consistent in the methodologies that they apply, and, as a result, the ratings are of limited utility for consumers of that information. A key consideration for ratings is consistency. For example, in May of 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. Regulators have begun to take action by publishing frameworks for ratings providers in the UK and in the EU.**