



Thomson Reuters Institute

Special report: ESG under strain



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Introduction: A perfect storm puts ESG momentum under strain

A nearly perfect storm of geopolitical, social, and economic forces is putting the environmental, social & governance (ESG) objectives of companies, investors, and governments under strain in 2022. Some of these forces might be short-lived, such as higher energy prices; others, including the political polarization of ESG issues in the United States, are more difficult to gauge. The most powerful, disruptive force, however, is arguably Russia's invasion of Ukraine, which created a pressing need to strengthen energy security and will likely require more fossil fuel extraction in the medium term.

Existing international pledges to cut carbon emissions to net zero by 2050 were already challenging. Governments and companies are now scrambling to balance their green ambitions with these new imperatives of energy security. The war exposed all too clearly what was already known: the dependency that many countries, particularly in Europe, have on Russia's oil and gas exports.

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Other stress points have emerged among those that in the past were leading champions of ESG issues. The world's largest asset manager, BlackRock, reduced its support for U.S. shareholder proposals on ESG issues by nearly half in this year's annual meeting season, as the firm voted for just 24% of them. The group had warned in May that shareholder ESG proposals were becoming too prescriptive, and that Russia's invasion of Ukraine had changed the investment calculus.

ESG has also become a political flashpoint in the United States, reflecting partisan differences and regional economies. While some states have issued extensive ESG mandates, others have adopted measures that seek to exclude banks supporting ESG policies on issues including climate change and gun control. Social issues have also come under scrutiny, and many companies are being caught in the political crossfire. In light of the U.S. Supreme Court overturning the Roe v. Wade decision guaranteeing abortion rights, some companies have adopted policies to help female employees to obtain abortion services, while some states have targeted those companies.

Still, amid the headwinds produced by such controversies there are notable developments. If anything, the Ukraine war should quicken efforts by Western governments, particularly in

Europe, to reduce their dependency on fossil fuels. Signs of more rapid change have already emerged. Germany, Europe's largest economy, agreed to a major package of reforms in July aimed at boosting the production of renewable power. The government expects to end purchases of Russian coal and oil this year, and of natural gas by 2024.

In the United States, Congress approved, and the President signed, the Inflation Reduction Act in August, which includes \$370 billion to support clean energy sources and speed the transition from fossil fuels. The new law is expected to accelerate private sector investment in renewable energy and will help the United States meet its net-zero emissions pledge by 2050.

Meanwhile, ESG regulatory efforts in the EU, the UK, and the Asia-Pacific region are gathering pace, with numerous proposals on company climate disclosures either already in effect or poised to come into force this year or next.

How these crosscurrents play out over the next year is difficult to predict. This report will focus on two problems that affect all companies and should be on the agenda of boards and senior management: the growing efforts of regulators to stamp out "greenwashing" and the uneven pace of ESG regulation among jurisdictions.

The importance of the underlying principles of ESG has not diminished; indeed, the imperative for companies to earn their social license appears to be rising.

Greenwashing – a growing risk for companies

With stakeholders, including consumers and investors, pressuring companies to demonstrate their ESG credentials, the risks of so-called greenwashing have grown. Greenwashing occurs when companies make exaggerated or misleading environmental claims regarding their products or efforts to reduce their carbon footprint.

Numerous legal cases over such claims have emerged in the past year in both the financial and non-financial sectors. For example, in 2021, Client Earth, a non-governmental organization (NGO), successfully sued the board of oil group Shell over the company's climate transition plan. Shell had claimed that its plan would reduce emissions by 45% by 2030; Client Earth said the reduction figure was 4%. A court in the Netherlands ordered Shell to redo its transition plan.

More recently, DWS, the investment arm of Deutsche Bank, is being investigated by U.S. and German financial regulators over whistleblower allegations from Desiree Fixler, the former head of sustainability at the firm. Fixler said the company had made misleading claims in its 2020 annual report that more than one-half of the group's \$900 billion in assets were invested using ESG criteria.

To date, the investigation has led to raids on both DWS and Deutsche Bank as well as the resignation of Asoka Woehrmann as chief executive of DWS in June 2022. The public prosecutor's office in Frankfurt, Germany said that "sufficient factual evidence has emerged that, contrary to the statements made in the sales prospectuses of DWS funds, ESG factors... were not taken into account at all in a large number of investments." The Frankfurt office called the potential wrongdoing "prospectus fraud."

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In the United States, the Securities and Exchange Commission (SEC) fined a Bank of New York Mellon investment unit for allegations it falsely implied some of the firms' mutual funds had undergone so-called ESG quality reviews. The federal regulator is also reported to be looking into Goldman Sachs and whether some of its mutual funds meet the ESG metrics proclaimed in the firms' marketing materials.

Greenwashing allegations have also emerged in other industries. The Swedish clothing company H&M is facing a class action lawsuit in New York for its marketing of "sustainability-made" garments and accessories. The complaint alleges that H&M's advertising is "designed to mislead consumers about its products' environmental attributes." Specifically, the suit is

focused on the company's use of "sustainability profiles", which are incorporated into H&M's website and displayed on the "product listing for hundreds of H&M items." An investigation of the profiles, according to the suit, found that they contained "falsified information that did not comport with underlying data."

For example, one sustainability profile stated that a dress used 20% less water to manufacture, when it actually required 20% more water. "The goal of H&M's advertising scheme is to market and sell products that capitalize on the growing segment of consumers who care about the environment, but H&M does so in a misleading and deceptive way," said the suit, which was filed in July 2022.

In Illinois, meanwhile, ALDI, a supermarket chain whose headquarters are in Germany, is facing a suit alleging that the company's Atlantic salmon products are misleadingly labelled as sustainably sourced. The plaintiff alleges that they bought the salmon at a premium because of its sustainable label, when in practice ALDI buys the fish from industrial fish farms whose practices and methods are said to be unsustainable and environmentally destructive.

Such cases are only a sample of legal actions facing companies in sectors ranging from the "clean beauty" market to bottled water for their misrepresentation of sustainable products or eco-friendliness.

Financial regulators take notice

Given the enormous amount of money placed in ESG investments, financial regulators are stepping up their oversight to prevent money managers from overstating the ESG nature of their products.

In late 2021, the International Organization of Securities Commissions (IOSCO), which includes regulators from the United States, Europe, and the Asia-Pacific region, published recommendations which its members are obliged to apply when scrutinizing how asset managers sell funds which tout ESG good practices.

"Setting regulatory and supervisory expectations is therefore fundamental to addressing issues relating to risk mismanagement and greenwashing," said Erik Thedéen, head of Sweden's financial markets regulator and chair of the IOSCO taskforce that drafted the recommendations. The recommendations cover what regulators should check for in asset managers' internal policies and procedures on such investments, and how they market funds that claim to be sustainable.

At the regional level, financial authorities are also more active. European regulators are now systematically examining green claims made by corporations as part of their regular supervisory activities. In April, the European Securities and Markets Authority (ESMA) published a review of financial disclosure documents issued by EU-based companies. It found 58% of issuers had failed to include both physical and transitional risks in their disclosures.

This echoed the findings of climate “stress tests” conducted separately in the last year by the European Central Bank (ECB) and the Bank of England. Both exercises concluded that banks were underestimating the risks to their balance sheets from a warming climate.

There is a clear knock-on effect for banks of the close supervision for non-financial corporates. The scrutiny means European banks are obliged to understand their customers’ climate risk activities to report their own numbers to regulators.

In June, Frank Elderson, a member of the ECB’s executive board, said the regulator had begun conversations with the EU’s biggest banks about their loan customers. “We have started to discuss real client cases to understand how thorough banks are being in their assessment of their clients’ sustainability trajectories,” Elderson said. “We are also piloting tools aimed at improving our insights into how well banks are identifying and responding to the transition risk of their corporate clients.”

The Asia-Pacific region is also placing more emphasis on greenwashing risks. New guidelines rolled out by the Monetary Authority of Singapore (MAS), which will take effect in January 2023, aim to reduce greenwashing risks and enable retail investors to better understand the ESG funds in which they invest.

MAS will require ESG-labelled funds to make continuous disclosures. Investors will receive annual updates on the extent to which the fund has achieved its ESG focus. The required information will include details on the ESG fund’s investment strategy, the criteria and metrics used to select investments, and details of any risks and limitations associated with the fund’s strategy.

Finally, while the U.S. financial regulators have lagged their European counterparts on many ESG issues, greenwashing is not one of them. The SEC case against BNY Mellon may be the first of many enforcement actions on greenwashing, experts said. “These are the first ripples of a wave of regulatory interventions that we are likely to see in the coming months,” reported Sonali Siriwardena, partner and global head of ESG at the law firm Simmons & Simmons.

Underscoring its focus on greenwashing, in May the SEC proposed a pair of rule changes aimed at preventing funds from making unfounded claims about their ESG credentials and enforcing more standardization of such disclosures. The proposals outline how ESG funds should be marketed and how investment advisors should disclose their reasoning when labeling a fund.

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Competition authorities also acting

It is not just financial regulators that are holding companies to account for greenwashing. In April, it was reported that the UK Advertising Standards Authority was investigating HSBC for greenwashing.

The UK Competition and Markets Authority (CMA) also has warned corporations against making unsubstantiated green claims. It produced a Green Claims Code last year which advised that firms should ensure they could substantiate environmental claims with up-to-date data. In August, the CMA said it was investigating fashion retailers Boohoo and ASOS and supermarket chain Asda for misleading sustainability claims.

In the United States, the powerful Federal Trade Commission (FTC) announced \$5.5 million in settlements with retail companies Kohl's and Walmart following eco-friendly claims about products that were marketed as made from "bamboo", when they were in fact made from the semi-synthetic fiber rayon. The FTC noted that the \$5.5 million the two retailers will pay amounts to the largest-ever civil penalty for such product marketing.

"False environmental claims harm both consumer and honest businesses, and companies that greenwash can expect to pay a price," said Samuel Levine, director of the FTC's Bureau of Consumer Protection, announcing the enforcement action.

Uneven international regulatory landscape

Companies with international operations have their work cut out when it comes to complying with ESG regulations, having to deal with a hodgepodge of rules and reporting requirements that challenge even the nimblest organization. Authorities in the EU and the UK have been particularly active. The European Commission, European Central Bank, Bank of England and ESMA all recently implemented new regulations, particularly on climate change. This momentum is unlikely to slow down.

In the United States, meanwhile, the SEC is poised to finalize a set of sweeping disclosure rules on greenhouse gas emissions for publicly traded companies. The proposed rules are lengthy, complex, and controversial. The SEC has received nearly 15,000 comment letters from interested parties, including investors, companies, legal experts, and environmental activists. The rules would require companies to report annually not only their own carbon emissions, but also those of their suppliers and customers. This last requirement, called "Scope 3" emissions, has drawn the ire of many industry groups. The rules are expected to be challenged in court once they are finalized, with critics arguing the SEC is overstepping its statutory authority in asking companies for such information.

Other U.S. financial regulators, such as the Office of the Comptroller of the Currency and the Commodity Futures Trading Commission, are working on their own initiatives, with some guidance expected later this year or in 2023.

In the Asia-Pacific region, authorities in Hong Kong, China, and Singapore have proposed numerous measures, many of which focus on climate disclosure rules and the creation of metrics and standards to better measure and compare company carbon emissions. Regulators have also explored how the financial sector can help companies transition toward renewable energy, as well as the development of carbon-trading markets.

EU and UK authorities press ahead

The EU remains ahead when it comes to enacting ESG-related rules and regulations. The Sustainable Finance Disclosure Regulation (SFDR), an EU Commission rule that took effect in March 2021, imposes mandatory ESG disclosure obligations for asset managers and other financial market participants. The SFDR's objective is to improve transparency, which helps to prevent greenwashing as well as to direct capital toward more sustainable investments, products, and businesses. The disclosure rules cover both environmental and social factors.

More recently, in July 2022, the EU published a review of the SFDR's requirement for asset managers to produce so-called principal adverse indicator (PAI) statements. PAIs are defined

as “negative, material, or likely to be material effects on sustainability factors that are caused, compounded by, or directly linked to investment decisions and advice performed by the legal entity.” In its review, the EU found that compliance varied significantly.

There are an initial 14 mandatory PAIs, including greenhouse gas emissions, hazardous waste ratio, board gender diversity, and gender pay gap. Producing a PAI statement requires an asset manager to collect this data from all the companies in which they invest.

Two further EU directives, the Corporate Sustainability Reporting Directive and the Corporate Sustainability Due Diligence Directive (CS3D), will soon up the ante for ESG disclosures. The former will require corporations with 500 or more employees, including banks and insurance companies, to publish a range of ESG data including on bribery and corruption. Crucially, this data must be audited externally.

CS3D, the due diligence directive, will apply to around 13,000 EU companies and 4,000 non-EU companies including finance firms. Among other requirements, it will require banks to guarantee that companies to which they make loans are not involved in human rights abuses.

The UK is also working on ESG laws. It has already mandated that UK-listed companies must report data that is aligned with the Task Force on Climate-Related Financial Disclosures (TCFD), an international body created by the Financial Stability Board to improve and increase reporting of climate-related financial information. The government also has set up a taskforce to produce an industry sector-specific transitions plan.

Most European financial firms and other companies are already using ESG data when making business and investment decisions. A call for evidence on the use of ESG ratings from the European Commission this year found that 75% of respondents — the majority of which are large corporate and financial firms — had integrated such ratings into their risk management processes.

CARBON CREDITS

The use of carbon credits is expected to accelerate in the coming decade as more corporations seek to offset carbon emissions on their path to net zero. A carbon credit is a generic term for any tradable certificate or permit representing the right to emit a set amount of carbon dioxide into the atmosphere. They have become an increasingly popular way for companies to meet their stated emissions goals.

Consulting firm McKinsey & Co. has estimated that the market for carbon credits will be worth \$50 billion by 2030 and possibly 100 times that by 2050.

Carbon credits can be nature-based, such as for projects linked to preventing deforestation; or technology-enabled, including the expanded use of renewables and

carbon capture. Such *voluntary carbon markets* should not, however, be confused with the *cap and trade* carbon emissions schemes such as those operated by the European Commission and California's state government. Under such programs, governments set the limit, or "cap" on emissions that is permitted across a given industry, then issue a limited number of annual permits that allow companies to emit a certain amount of carbon dioxide.

Regulators as well as enthusiasts for voluntary carbon credits have been clear that the use of carbon credits should be in addition to, not a substitute for, companies' efforts to reduce their carbon footprints. Transition plans will help companies identify whether using carbon credits might be desirable.

There are considerable risks attached to firms' use of carbon credits — they have a somewhat controversial history, with many turning out to be scams.

Agreement on Article 6 of the Paris Climate Accord at the UN Climate Change Conference (COP26) last year has galvanized efforts to bring much-needed credibility to carbon credits. The UN is establishing a supervisory body to oversee the development of Article 6.4, pertaining to carbon credits. Initial proposals of the supervisory body will be discussed at the next climate conference in November.

Several private sector initiatives are also underway. The Integrity Council for Voluntary Carbon Market is an independent governance body for the voluntary carbon market. It was set up last year in response to the final recommendations of the Taskforce on Scaling Voluntary Carbon Markets. The taskforce was an initiative of Mark Carney, former governor of the Bank of England, and Bill Winters, chief executive of Standard Chartered. Its final report in January 2021 estimated that the voluntary carbon market could reduce carbon emissions by 2 billion tonnes by 2030 and be worth \$50 billion.

The Integrity Council published draft core principles in July 2022, with the aim of providing assurance that projects producing carbon credits are removing carbon from the atmosphere. It hopes to begin approving carbon credit accreditors by the end of the year.

Separately, a group of investment banks has created Carbonplace, a settlement platform for corporations looking to use carbon offsets as part of their net zero transition planning. National Australia Bank, Itaú Unibanco, Standard Chartered, BNP Paribas, UBS, Canadian Imperial Bank of Commerce, and NatWest are the banks behind the platform, which completed a pilot transaction for Visa earlier this year.

The intention is that Carbonplace will become a SWIFT-like system for carbon markets and be operational by the end of the 2022.

U.S. regulation lags, but important developments are ahead

The SEC's proposed rules for climate disclosure by public companies represent the first major step by a U.S. regulator on ESG issues. The final rules, due later this year or in early 2023, will mark an important milestone in future ESG regulation. They are expected to provide investors with better information about what companies are doing to reduce their carbon footprint, and are likely to be complemented in due course by rules that enhance transparency on social issues, such as board and company diversity, employee compensation, and other stakeholder concerns.

SEC climate disclosure proposal

The SEC's climate disclosure proposal would require companies to publish their direct emissions, known as Scope 1, as well as emissions derived from their electricity needs, or Scope 2, in their annual SEC filings.

The most controversial aspect of the agency's proposed rules involves emissions that arise from a company's supply chain, or so-called Scope 3. This group of emissions is considered the biggest and broadest component of a company's pollution and is difficult to measure. According to some estimates, Scope 3 emissions account for about 88% of total emissions from the oil and gas sector.

Under the SEC plans, Scope 3 emissions would need to be disclosed only if they were deemed "material", or part of companies' climate targets. Scope 3 disclosures would also not be subject to third-party verification and firms would be protected via a "safe harbor" from legal liabilities.

Apart from a company's greenhouse gas emissions, the proposed rule mandates several other disclosures:

- The company's governance of climate-related risks and relevant risk management processes.
- How any climate-related risks identified by the company have had or are likely to have a material impact on its business and consolidated financial statements.
- How any identified climate-related risks have affected or are likely to affect the firms' strategy, business model, and outlook.
- The impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a company's consolidated financial statements, as well as on the financial estimates and assumptions used in financial statements.

Court challenges expected

The SEC has received an avalanche of comment letters from a wide range of investors, companies, legal experts, and environmental activists. Many support the agency's efforts, but those efforts have also attracted criticism. Once the SEC's rules are finalized, they will undoubtedly meet resistance, most likely in the form of court challenges with several powerful industry groups already signaling such intentions. What will emerge at the end of the legal wrangling is unclear in the face of a U.S. Supreme Court that has cast a skeptical eye on regulators in general. Climate disclosure rules in some form are likely to become law, however, and companies should make preparations.

Politicization of ESG issues

In the background, 2022 has been mired in an increasingly polarized partisan political debate with regards to ESG issues and the role the federal government should play. In seeking to undermine ESG policies in the private sector, some states have implemented laws against companies that embrace climate-related objectives or social issues.

According to recent reports, there are 44 bills or new laws in 17 states — including Oklahoma, West Virginia, Arkansas, and Kentucky — that seek to punish Wall Street firms for taking stances on issues ranging from gun control and abortion to diversity and climate change.

Looking ahead, government agencies' ESG initiatives could come under more intense scrutiny. U.S. Republican lawmakers are preparing a crackdown on the consumer and securities regulatory bodies amid speculation they will gain control of a key congressional committee following the November mid-term elections, according to financial lobbyists, congressional staffers, and lawmakers.

With the possibility of the U.S. House of Representatives flipping to Republican control (according to recent poll-tracking organizations), Republicans on the House Financial Services Committee are planning investigations into the Consumer Financial Protection Bureau and the SEC. Many Republicans allege that the agencies, which have operated under Democratic leadership since January 2021, have overstepped their authority, flouted the legal process for writing rules, and adopted a hostile stance toward the industries they regulate.

Biden administration victory on climate legislation

Despite the heightened challenges companies face on ESG across numerous U.S. states, the passage into law of the Inflation Reduction Act (IRA) in August marks the single largest action ever taken by Congress and the United States government to combat climate change.

"IRA is a game changer for U.S. decarbonization," according to the Rhodium Group, which found that the \$370 billion devoted to climate change will drive down U.S. net greenhouse gas emissions 32% to 42% below 2005 levels in 2030, compared with 24% to 35% without it.

"The long-term, robust incentives and programs provide a decade of policy certainty for the clean energy industry to scale up across all corners of the U.S. energy system to levels that the United States has never seen before," the group said in its analysis of the IRA.

The new law's incentives will also help reduce the "green premium" on clean fuels, clean hydrogen, carbon capture, direct air capture, and other technologies, potentially creating the market conditions to expand these industries to the level needed to maintain momentum on decarbonization into the 2030s and beyond.

For the United States to meet its 2030 target of reducing emissions by 50% to 52% below 2005 levels, however, more work is needed. "With the IRA enshrined as law, all eyes will be on federal agencies and states, as well as Congress, to pursue additional actions to close the emissions gap," Rhodium stated.

Asia-Pacific region authorities becoming more active

Three countries in the Asia-Pacific region are defining the ESG regulatory landscape. China, Singapore, and Hong Kong in the past year have made significant strides in developing ESG metrics, taxonomies, and disclosure practices for companies, as well as launching carbon trading markets. Despite this progress, some leaders argue more is needed, particularly from the financial sector.

"Where the industry needs to do better is in transition finance — to provide the funding support for companies that are not so green, to become greener," Ravi Menon, managing director of the Monetary Authority of Singapore (MAS), said in the regulator's annual sustainability report.

Transition bonds, issued by firms to finance efforts to reduce their environmental impact, are one tool. Last year, 12 transition bonds were issued worldwide with a value of \$4.4 billion, while the value of green and sustainable bond issuance amounted to \$800 billion, a ten-fold increase since 2015.

"The transition bond market has good potential to grow," Menon said.

Comparable and reliable sustainability data are critical to the development of transition plans, and to track progress. MAS has identified two priorities: *i*) standardizing the taxonomy for transition activities and making it interoperable with other major taxonomies; and *ii*) improving the ease with which financial institutions can access relevant ESG data.

To that end, MAS is supporting the development of an industry-led green and transition taxonomy. The Green Finance Industry Task Force has defined the environmental objectives of the taxonomy and identified eight focus sectors for the first phase. For the second phase, it has set out detailed thresholds and criteria to classify activities as green or amber for economic activities in the energy, building, and transportation sectors.

Separately, the Singapore Exchange (SGX) published a consultation paper last December setting out a common set of ESG metrics for SGX-listed companies to start with a common set of ESG metrics; some 27 metrics have been developed to assist issuers and investors with measuring ESG issues. The list is divided into the three ESG categories: environmental, social, and governance. Under the environmental category, topics include greenhouse gas emissions, energy, and water consumption. Under social issues, SGX included gender diversity, age-based diversity, and employment. Governance includes board composition, management diversity, and ethical behavior.

According to SGX, climate reporting is mandatory for all issuers on a "comply or explain" basis this year. In 2023, reporting will be made mandatory for listed businesses in the financial, energy, agriculture, food, and forest products sectors. From 2024, reporting will be made mandatory for businesses in the materials and buildings and transportation sectors.

China focuses on disclosure and carbon reduction

China, the world's biggest polluter, has committed to reducing peak carbon emissions by 2030 and net zero emissions by 2060.

The China Enterprise Reform and Development Society, a think-tank under the Chinese government's state-owned Assets Supervision and Administration Commission, has teamed up with some of the biggest Chinese companies to release the country's first ESG disclosure standards — "Guidance for Enterprise ESG Disclosure."

The voluntary guidelines, which became effective on June 1, 2022, provide a glimpse of what mandatory disclosures might eventually look like in the country. The guidelines list more than 100 metrics that are in line with the benchmark of draft rules issued by the International Sustainability Standards Board (ISSB) at the COP26 UN climate change summit in 2021.

"The ESG Disclosure Standards seek to fill a gap in corporate ESG disclosure reporting in mainland China and promote the accuracy and effectiveness of information disclosure by Chinese enterprises," the law firm Linklaters wrote in an analysis.

The standards set out a comprehensive indicator system for disclosure of "scientific and measurable" data across each "first-level indicator" of ESG, working down to a fourth tier of no less than 118 more granular indicators, the law firm said. "The guidelines specify disclosure principles, indicators, requirements, applications, responsibilities, and supervision for businesses of different types, industries, and sizes. The aim [is] to support Chinese enterprises in their ESG governance practices and disclosure," Linklaters wrote.

“1 + N” policy framework

The Chinese government has also been working on a 1+N policy framework on industry carbon emissions. The 1 refers to a long-term approach, while the N signifies solutions toward a 2030 goal of peak carbon emissions. The framework will include a “carbon peaking action plan” that sets out Beijing’s expectations for the actions that particular sectors are required to take on emissions.

Such a plan will cover actions from all major emitting sectors, including energy, industry, infrastructure, and transport, as well as other significant policy areas for climate action, including technology, finance, economic policies, carbon trading, and nature-based solutions.

“On energy, the plan is expected to reiterate China’s pledge to build a ‘power system based on new energy’, which includes green hydrogen and nuclear, ‘strictly limit’ coal consumption until 2025, and phase it down thereafter,” said Xie Zhenhua, China’s climate envoy.

China has also been active in developing market trading systems that are focused on carbon emissions. The country officially launched its first national carbon emission trading scheme in July 2021, as well as the Beijing Green Exchange, which is the national trading platform for voluntary carbon credits.

In addition, a mandatory environmental information disclosure system will be set up by 2025, and will mainly cover heavy polluters, listed companies, and bond issuers with a poor record in environmental protection.

Hong Kong initiatives on disclosure, board diversity and carbon markets

The Hong Kong government published its Climate Action Plan 2050 last October, with the goal of achieving carbon neutrality by 2050. The government also committed to a more ambitious medium-term target to reduce total carbon emissions by half against 2005 levels before 2035.

In November 2021, the Hong Kong Stock Exchange (SEHK) published its “Guidance on Climate Disclosures”, to facilitate corporate issuers’ compliance with the TCFD recommendations.

The SEHK also published the conclusions to its April 2021 white paper, which provided that a company’s board of directors should consist of both genders, stating that a “single-gender board is not considered to be a diverse board.” The change must be implemented by December 31, 2024. In addition, the SEHK published the “Practical Net-Zero Guide for Business” to help companies develop a pathway to net zero. It also established a partnership with ESG data providers to display the ESG metrics of listed companies.

Hong Kong Exchanges and Clearing Ltd., the parent company of the SEHK, set up the Hong Kong International Carbon Market Council in July this year which will oversee the development of a voluntary carbon market in due course. The inaugural members include HSBC, Standard Chartered, BNP Paribas, ANZ, Industrial and Commercial Bank of China, and Bank of China.

Further, the Securities and Futures Commission of Hong Kong has said it will work with entities including the SEHK and the China Securities Regulatory Commission, as well as IOSCO, to support the ISSB's work on sustainability disclosures.

BLUE BONDS

Blue bonds – debt instruments issued by governments or development banks to finance projects that protect the oceans – are less well known than their *green bond* (land-based) sustainability finance counterparts. There is, nevertheless, growing recognition that the world's oceans and waterways can also be used to sequester carbon.

The World Bank negotiated the first blue bond in 2018 for marine protection in the Seychelles.

Blue bonds are also being used to remove plastic from rivers and oceans. They are aligned to Goal 6 (clean water and sanitation) and Goal 14 (life below water) of the UN Sustainable Development Goals (SDG).

The UN Global Compact, which promotes the SDGs, said that the blue bond market in 2022 is a decade behind the green bond market, with \$1 trillion of issuance, but it expects the market to grow rapidly.

How to navigate ESG under strain

The COP26 meeting in Glasgow at the end of 2021 appeared to define a clear direction for ESG. The International Sustainability Standards Board had put forward its thinking on disclosure and reporting requirements, and financial services firms appeared to be gearing up to meet the emerging expectations.

Since then, the world has shifted. The war in Ukraine has led to the imposition of sanctions on Russia and the associated impact on energy supplies, as well as economic and supply chain issues. Financial services firms must also grapple with the distinctly different approaches to climate risk legislation taken by various jurisdictions. The expectations and reputational risk associated with ESG will continue to morph, and firms and their boards must keep on top of these developments.

Boards must take the lead in terms of the governance required to deliver on ESG. Without effective corporate governance, financial service firms and others will be unable to deliver the required breadth of environmental and social challenges.

"A more consistent global approach to addressing climate-related risks will help to better assess and mitigate financial vulnerabilities and to reduce the risk of harmful market fragmentation."

— *Financial Stability Board, interim report on Supervisory and Regulatory Approaches to Climate-related Risks (April 2022)*

Defining the challenges around ESG approaches

These challenges will require focus and resources if firms are to navigate ESG compliance safely. Some areas for firms to consider as part of their approach to ESG include:

Data governance

To comply with the burgeoning data requirements associated with ESG, firms need to accept that data is a vital strategic asset. They must build a business-wide and business-specific approach to data governance that addresses data aggregation, management, storage, security, retrieval, and destruction. Many firms will need to make a significant investment in their data governance capabilities, to enable them to accurately and repeatedly respond to the growing number of ESG-related data requests.

Some have already set up dedicated departments to inform ESG strategy and to respond to ESG-related data requests. Others are aligning the ESG customer data-gathering

requirements with those in their know-your-customer functionality. In whichever way firms choose to manage and report data, they must have a clearly articulated and “even” approach; specifically, one which minimizes the potential for customers to be unclear about why the additional information is being sought or for them to seek to arbitrage between firms and their ESG data stance.

Skills

The talent war for ESG experts has begun. Firms need to undertake a skills analysis and fill any gaps as a matter of urgency. In the financial services world, it is unlikely that an untrained board or leadership team will find any sympathy with regulators. The UK Financial Conduct Authority has made public that its own board has received specific training on ESG and that it has created a specialist ESG advisory committee. ESMA is building its skills through, among other things, the creation of a Consultative Working Group of the Coordination Network on Sustainability, composed of experts in sustainable finance.

In the United States, the SEC has made climate-related risks an examination priority and has created a climate and ESG task force within its Division of Enforcement.

Given this, firms would be well-advised to invest in and strengthen in-house ESG skills to help better inform and manage the delivery of all ESG and related objectives.

Lobbying

Climate risk is unlike other financial risks. Its uniqueness, complexity, and long-term nature make quantifying the threat one of the biggest hurdles for regulators as they develop new rules and regulations. Firms need to engage with regulators to ensure that “good” regulations are developed — poorly designed regulations will not achieve the required aims and are expensive to fix.

There are several areas of engagement and lobbying for firms to consider:

- Firms need to invest in skilled resources to help them respond to relevant consultations, discussion papers, and local equivalents. Even if the apparent chances of getting a regulator or policymaker to alter its approach are small, they will be nil if firms fail to respond. Firms may wish to coordinate among themselves or trade bodies to add weight to arguments where compliance will be unduly onerous, or the approach will be unlikely to meet the required ESG outcomes. Even if a firm supports a proposal, it should still respond as there may be those that are arguing against the approach.
- Firms also need to submit detailed written responses, preferably with practical examples, if they wish to follow up with either domestic or supranational policymakers. Any firms approaching either type of body without having submitted a detailed, reasoned response to any formal consultation process will be given short shrift.

- A well-trodden lobbying path has been for firms, often through third-party lobbyists, to engage with relevant politicians to convey particular points. Firms must appreciate that politicians tend to deal at the legislative rather than regulatory level of proposed changes. Big-picture concerns can be raised and discussed, but any and all arguments will need to address relevant ESG outcomes and sustainability issues.
- Board engagement is essential to any lobbying strategy. The current uncertainties as to practical ramifications are also an opportunity to seek to shape the new world to a firms' advantage. As a first step, firms need to think through the implications for their own business of all potential changes and then take a senior-level decision as to what *good* looks like for their business. In this sense, *good* could include a scenario which is neutral for the firm itself but potentially a significant threat for its competitors. Equally, if a possible threat is bad for the firm, it might end up being worse for competitors, leaving the firm in a relatively better position.

Messaging

A vital element of a firms' strategic approach to ESG will be its external messaging.

The approach to messaging covers the entire spectrum from potential greenwashing to advertising that highlights a firms' green credentials. Firms must have a clear strategy, with the board not only setting the approach but also having clear line of sight to the messaging itself. Indeed, a critical part of any messaging will be a firms' ability to demonstrate that the message portrayed is accurate.

"The rules are clear. Ads that make environmental claims need to make the basis on which they are made easy to understand. They need to consider the whole lifecycle of a product or service unless it's clear that a more limited claim is being made. They must take care not to over-claim, and they must not omit key information. Objective claims require evidence to be held at the time the ad appears. They must be socially responsible, too.

"When you're constructing a claim, keep it simple. Be precise. Limit the claim to what you are really trying to draw attention to. And beware of making big, bold, absolute claims unless you are certain you can back them up."

— UK Advertising Standards Authority (June 2022)

Financial services firms are often subject to a double layer of rules on advertising. There are the wider rules about advertising in general — the UK Advertising Standards Authority, for instance, has already opined on multiple advertisements where the environmental or ESG claims were not backed up by the required evidence.

Financial advertisements and products or services being offered are subject to more detailed requirements and scrutiny. That scrutiny is both internal and external, with increasingly high stakes for those firms found to be greenwashing.

Reputational risk management

Akin to the need for oversight of all ESG messaging is the need to manage a firms' reputational risk. All firms are anxious to prove their green credentials and are making increasingly bold statements and promises to that effect.

No one has doubted the good intentions associated with the setting of net-zero or net-negative targets, but any roadmap should be accompanied by contingency plans for the reputational risk management which may be needed if targets are not met, or the roadmap is changed.

Firms' reputational risk management must also encompass the route to achieve whatever targets have been set. Firms have used various carbon offsetting schemes to help manage and reduce carbon footprints, but these have not been without risk. For instance, firms were reported to have bought extensive forests which were then destroyed by wildfires, leaving their approach to carbon offset potentially severely dented.

Carbon credits and carbon trading are entering the mainstream, but firms need to be aware that offsetting their carbon is unlikely to be reputationally sufficient if it is seen as a means of avoiding tackling carbon creation or as a cover for being slow in their own approach to ESG. Continuing scientific developments will make the approach to many of the environmental aspects of ESG a moving target.

Firms will need to stay in touch with both the data-gathering and reporting elements of ESG as well as emerging best practices in terms of sustainability and carbon reduction. Today's carbon-capture bright idea may well be superseded in time, and firms will need to ensure that they are keeping up with the technological and scientific environmental solutions.

"By 2030, Microsoft will be carbon negative, and by 2050 Microsoft will remove from the environment all the carbon the company has emitted either directly or by electrical consumption since it was founded in 1975."

– Official Microsoft blog (January 2020)

Closing thoughts

ESG may have lost some of its momentum in 2022 for a variety of reasons, but the underlying proposition remains essential, particularly for companies with international operations. Its importance has not yet peaked. One might argue that the imperative for companies to earn their social license appears to be growing, given the geopolitical, social, and climate events witnessed so far this year.

The extraordinary weather events playing out worldwide are an all-too potent reminder of the responsibilities that government and the business community have in reducing carbon emissions. Speed is of the essence. The decision by the United States to approve the largest climate bill in its history is a clear indication of movement.

On social issues, Russia's invasion of Ukraine was a call to action for all companies with operations in Russia. Many pulled out of the country, putting corporate values ahead of profit or recognizing the potential business backlash should they remain. Further challenges are ahead, as evidenced in the political battles brewing on issues such as reproductive rights in the United States.

This report highlights some of the risks for companies during such turbulent times. It is increasingly clear that companies will be held to account for what they say they are doing on ESG by governments and regulatory bodies. In addition, companies must align their operations to take account of burgeoning ESG rules and regulations, particularly in terms of disclosing what their carbon emissions are in the various countries in which they operate. This also applies to social issues in the EU and, increasingly, in the Asia-Pacific region. While regulatory oversight may be evolving at different speeds in different jurisdictions, companies cannot ignore the fact that ESG has become a regulatory and reputational risk.

Regulators, investors, and other stakeholders, including environmental groups and non-governmental organizations, will all be keeping a watchful eye on what companies are doing to combat climate change and manage social issues. ESG is not going away anytime soon.

Appendix: G20 round-up

Argentina

Argentina's capital markets regulator, the Comisión Nacional de Valores, has implemented several initiatives aimed at advancing the development of sustainable finance. This has included producing guidelines on socially responsible investment, on the issuance of social, green, and sustainable bonds, and on the evaluation of social impact bonds.

Australia

Following the release in late 2021 of its guidance on managing the financial risks of climate change, the Australian Prudential Regulation Authority has sought during 2022 to assess the extent of alignment between firms' existing practices and its guidance. Responding to concerns about greenwashing, the Australian Securities and Investments Commission has set out its expectations of firms offering or promoting sustainability-related products.

Brazil

The Central Bank of Brazil, which is independent of the government, has introduced rules requiring financial institutions to disclose more information relating to social, environmental, and climate change-related risks. The rules are derived from the recommendations of the international Task Force on Climate-Related Financial Disclosures, but not limited to a climate perspective. Under them, banks must produce an annual report on social, environmental, and climate-related risks and opportunities from a reference date of December 2023 onwards. Also, Brazil's insurance regulator has consulted on a draft circular setting out sustainability requirements to be observed by insurance firms.

Canada

The Office of the Superintendent of Financial Institutions has consulted on guidelines to mitigate the financial risks from climate change. Under the guidelines, firms would be required to make annual climate-related disclosures on governance, strategy, risk management, metrics and targets, and greenhouse gas emissions, as well as produce a transition plan, for periods starting October 2023. The Canadian Securities Administrators also has issued guidance for ESG funds earlier this year. The guidance calls for alignment between a fund's name and investment objectives, disclosure of investment strategies used to achieve objectives, and explanations of how ESG factors are evaluated and monitored.

China

The China Banking and Insurance Regulatory Commission has issued green finance guidelines for the banking and insurance sectors. Under the guidelines, firms are required to implement a new approach, which includes improving their ESG performance and promoting their transition to net zero. The guidelines also require firms to allocate responsibilities for developing and implementing a green finance development strategy to senior managers.

France

Under a framework created in July 2019, France's conduct and prudential regulators monitor and evaluate climate-related commitments made by banks, insurers, and asset managers. In their second annual report (published in late 2021) they noted a strengthening of commitments (such as divestment and exclusion policies) among firms. The regulators have also examined non-financial reporting among some listed companies on climate issues and made recommendations for improvements.

Germany

Following the issuance of non-binding guidance for firms on dealing with sustainability risks (which it defined based on ESG criteria), the German regulator BaFin last year released the findings of a survey examining how the financial sector was dealing with such risks. Among the findings was that, while few firms had discontinued entire business segments, a significant number had restricted some business areas because of sustainability risks. BaFin also has consulted on introducing new rules for sustainable investment funds which would establish minimum requirements for those funds offered for sale to investors as explicitly *sustainable* either on the basis of their name or their description in marketing.

India

The Securities and Exchange Board of India has consulted on introducing a regulatory framework for ESG ratings providers. The framework would set the standardization of symbols and scales for ESG ratings, establish requirements in relation to governance and preventing conflicts of interest, and seek to ensure transparency in their decision-making process.

Indonesia

The beginning of 2022 saw the Indonesian Financial Services Authority issue the first version of a green taxonomy. The taxonomy was intended to help accelerate financing and investment in green projects and prevent the potential for greenwashing, it said.

Italy

The Bank of Italy in April 2022 published an initial set of supervisory expectations on the integration of climate and environmental risks into corporate strategies, governance and control systems, risk management frameworks, and disclosure requirements of supervised firms. Other supervisory work in Italy has included engagement with the boards of less significant firms to ascertain their level of awareness of environmental risks, and analyzing the way asset managers are incorporating ESG factors into their business processes.

Japan

The Japanese Financial Services Agency adopted a strategy on sustainable finance which identified several goals for the period of July 2021 to June 2022. Following a revision of the corporate governance code, listed firms are now required to make disclosures consistent with the recommendations of the Task Force on Climate-related Financial Disclosures. Other work by the regulator includes developing guidance on addressing climate-related risks and opportunities and drafting a code of conduct for ESG evaluation and data providers.

Republic of Korea

In late 2021, South Korea's Financial Services Commission and the Korea Exchange jointly launched an integrated ESG information platform. The platform, which includes information on listed firms' ESG activities, ratings, and sustainability reports, is intended to be a "one-stop information service on ESG-related information of listed companies for investors and the wider public," they said. ESG disclosures for listed firms in Korea are due to be mandatory from 2030 onward.

Mexico

In a declaration released last year, Banco de México provided details of a range of actions it was undertaking in sustainable finance. These include establishing a committee tasked with developing a sustainable finance taxonomy, integrating ESG risk factors into supervisory and financial market activities, improving the amount and quality of disclosures and reporting by both financial and non-financial institutions, and enabling conditions to increase sustainable capital mobilization. The central bank also indicated it expected to complete work on a framework to assess climate-related macro-financial risks with a forward-looking perspective during 2022.

Russia

Among the eight priority areas identified by Russia's central bank for the development of the Russian financial market between 2022 and 2024 is the enhancement of the financial market's contribution to sustainable development goals. The central bank has previously written to listed firms recommending disclosures on how they consider ESG factors and incorporate them into their business models and development strategies.

Saudi Arabia

Under its Vision 2030 strategy, Saudi Arabia has set out to create a more sustainable future. As part of the effort toward advancing ESG issues, the Saudi Exchange has published ESG disclosure guidelines which are intended to help in developing best practices. The guidelines provide definitions and recommendations on preparing sustainability reports.

South Africa

A government technical paper on financing a sustainable economy, which was updated in 2021, includes a recommendation on adopting a definition of *sustainable finance*. It also recommends that regulators and the financial services industry co-develop or adopt guidance on identifying, monitoring, reporting, and mitigating their environmental and social risks. The technical paper also recommended the adoption of a taxonomy for green, social, and sustainable finance initiatives that was consistent with international developments.

Turkey

Turkey's Capital Markets Board has produced guidelines on green debt instruments, sustainable debt instruments, green lease certificates, and sustainable lease certificates. The guidelines establish basic principles for the issuance of such debt instruments and the minimum standards to be met. The Capital Markets Board has previously issued a sustainability principles compliance framework which sets out sustainability principles to be followed by listed firms. Adherence with the principles is on a "comply-or-explain" basis.

United Kingdom

The UK government has issued a roadmap toward the introduction of new sustainability disclosure requirements. The new requirements are intended to build on the UK's implementation of TCFD-aligned disclosures and create an integrated framework. The government also has formed a task force to provide it with advice on developing a green taxonomy.

United States

U.S. President Joe Biden vowed upon taking office last year to take a "whole-of-government" approach to fighting climate change, establishing a task force among 21 federal agencies to oversee the process.

The SEC has set out proposals for rule changes aimed at preventing unfounded claims by funds that are marketing ESG investments. The SEC also has proposed a draft rule that would require public companies to disclose a range of greenhouse gas emission figures. There has been evidence of some pushback at the state level to the fossil fuel divestment commitments made by some firms. This has included threats to limit or bar firms making such commitments from some financial activities within a state.

The U.S. Federal Reserve has also pledged to address the implications of climate change within the bounds of its authority to regulate and supervise financial institutions.

European Union

The European Commission's proposal to update its non-financial reporting directive with a corporate sustainability reporting directive has all but cleared its last political hurdle prior to adoption. The directive will require large firms to report on sustainability issues such as environmental and social rights. Amendments have also been made to established retail frameworks such as EU Directive 2014/65/EU (commonly known as MiFID II) to integrate sustainability considerations.

International developments

Among developments from standard-setting bodies has been: *i*) the release by the Basel Committee central bankers' organization of principles for the effective management and supervision of climate-related financial risks; *ii*) recommendations from the International Organization of Securities Commissions applicable to ESG ratings and data product providers; *iii*) a consultation from the International Sustainability Standards Board on exposure drafts of proposed climate and general sustainability disclosure requirements; and *iv*) the publication of an interim report by the Financial Stability Board on supervisory and regulatory approaches to climate-related risks.

Among stakeholder-led initiatives, there has been work toward developing a framework for nature-related financial disclosures and a draft framework for producing net-zero transition plans.

Credits

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