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Bank of England Issues Updated Assessment of Climate-Related Risks and Regulatory Capital Requirements for Financial Institutions

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The Bank of England released a report titled **Climate-Related Risks and the Regulatory Capital Framework** (Report) on March 13, 2023. The Report expands on the Bank's 2021 **Climate Change Adaptation Report** (CCAR), in which it articulated initial views on existing regulatory capital frameworks for banks and insurers in relation to climate change. The CCAR concluded that the frameworks already in place, such as then-existing capital models and credit ratings, captured climate-related risks "to some extent." The Bank's updated assessment as set forth in the Report adopts a more cautious tone, concluding that the risk assessment "may be incomplete due to the difficulties in estimating climate risks (capability gaps) and there may be challenges in capturing risks in the existing capital regimes (regime gaps)."

According to the Report, these existing "capability and regime gaps" create uncertainty around whether banks and insurers are capitalized sufficiently for risks of climate-related losses in the future. The Bank observed that this uncertainty represents a "risk appetite challenge" for regulators, who "need to form judgements on whether quantified and unquantified risks are within acceptable risk levels." The Bank also stated that effective risk-management controls can reduce "the quantum of capital required in the future for resilience" to climate change losses, but "the absence of controls might suggest a greater quantum of capital will be required." In the short term, "the Bank is focused on ensuring firms make progress to address 'capability gaps' to improve their identification, measurement and management of climate risks." The Bank will undertake further analysis to explore whether changes to regulatory capital frameworks will be required. In particular the Bank will: develop its capabilities and forward-looking tools to determine the resilience of the financial system to climate risks; support initiatives to enhance climate disclosures; promote high quality and consistent accounting for climate risks; and address material regime gaps in capital frameworks.

Taking The Temperature: The Bank is focused on ensuring that climate change risks and the opportunities that may arise from a transition to a net-zero economy are being identified and managed across the financial sector. Instead of proposing any specific policy changes, the Report paves the way for further work by the Bank to explore and determine what changes (if any) need to be made to existing regulatory capital frameworks. The Report recognized that the "unique characteristics of climate risks mean that their capture by capital frameworks requires a more forward-looking approach than used for many other risks. Scenario analysis and stress testing will play a key role in this." The emphasis on scenario analysis in conjunction with overall risk assessment mirrors the importance placed on such exercises by other financial regulators, including the Federal Reserve and the European Banking Authority. Financial institutions should

also note the Bank's conclusion that increased capital requirements may be needed to address any absence of controls: because the Bank, like the European Parliament and national bank regulators elsewhere, have highlighted the use of the Basel III regime to address material climate risks, the Bank or the Prudential Regulation Authority very well could take action to address any significant capital or supervisory weaknesses.

CDP Reports Limited Progress on Scope 3 Nature-Related Disclosure

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According to a **recent report** published by global non-profit environmental disclosure platform CDP, approximately 41% of responding companies are reporting on one or more categories of supply chain emissions, even though such emissions on average are 11.4 times higher than operational emissions. The reasons for this disparity vary, but include “limited data transparency and traceability across the value chain;” low quality data; limited influence over Scope 3 categories; and evolving regulatory regimes. The Report also observes that relatively few companies have adopted Scope 3 targets (15% of new or in-progress targets) and only 5% have targets based on the Science Based Targets initiative, while over 60% do not engage their supply chain on climate-related issues.

The Report also focused specifically on biodiversity supply chain issues, with a particular focus on water consumption and deforestation. Almost 70% of companies reported that they currently do not assess the impact of their value chain on biodiversity generally. With respect to water, CDP states that “not many companies currently quantify the water footprint of their supply chain,” perhaps in part because “unlike climate change, there is no accounting methodology to work out the pure metrics required for supply chain water consumption.” Of responding companies, 23% reported engaging suppliers on water-related issues. As for deforestation, about half of the responding companies have a “system to control, monitor or verify compliance with forest-related commitments and policies,” while about a third have a monitoring system for direct and supply chain deforestation. Almost 70% of companies surveyed reported engaging with direct suppliers on forest-related issues. And, overall, CDP **concludes** that senior management teams currently are not sufficiently incentivized to “address key issues such as water security and deforestation in the supply chain.”

The Report follows the adoption at COP15 of a **global biodiversity framework**. The framework established a number of ‘short-term’ targets to be reached by 2030, which includes target 15: to “[t]ake legal, administrative or policy measures to encourage and enable business, and in particular to ensure that large and transnational companies and financial institutions: (a) [r]egularly monitor, assess, and transparently disclose their risks, dependencies and impacts on biodiversity, including with requirements for all large as well as transnational companies and financial institutions along their operations, supply and value chains and portfolios.”

Sonya Bhonsle, Global Head of Value Chains & Regional Director Corporations at CDP, stated that "COP15 couldn't have been clearer in the call to action on corporate reporting on nature. If a company is not preparing for incoming regulations and stakeholder interest on addressing nature in the supply chain, they are open to a wide range of risks and could also be missing out on the opportunities that safeguarding nature will bring. Quite simply, if a company wants to be in business in the future, they need to start embedding nature into the way that they buy and collaborating with suppliers to drive action in the supply chain."

Taking The Temperature: As recently reported, the investigation carried out by the International Consortium of Investigative Journalists into deforestation shows the increased scrutiny being paid to biodiversity impacts, including from regulators. Companies should take steps to ensure their processes are robust and will stand up to external review. CDP's report on tracking nature across the supply chain, however, shows that Scope 3 emission reporting continues to split opinions. Engaging with the full value chain is a burdensome and time consuming process, especially for large international organizations that source and supply products globally. Outside the U.S., the trend is to require disclosure of Scope 3 emissions, including in the European Union, based on established standard setters such as the International Sustainability Standard Board. The picture in the U.S. is less clear. For instance, California's Senate is currently reviewing a proposed bill that, if passed, would require all large companies operating in California to report on their full range of emissions, including indirect emissions from value chains. On the other hand, there has been speculation that the SEC may remove or slim down the Scope 3 emission reporting requirements in its proposed climate-related disclosure rule. Ultimately, it is not surprising that supply chain emissions measurement and disclosure remain a challenge. Because these are value-chain emissions, by definition third parties, not the issuer itself, have the relevant greenhouse gas information. It is not clear that issuers will be able to obtain all such information in order to provide complete and accurate reporting, not to mention the potentially significant costs involved in doing so and the potential for double-counting given that one issuer's Scope 3 emissions are another company's direct emissions.

Malaysian Stock Exchange to Launch ESG-Reporting Platform

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On March 22, 2023, Malaysian stock exchange Bursa Malaysia and the London Stock Exchange Group **announced** the development of a centralized ESG-reporting platform (Platform), due to launch in April 2023. The Platform has been designed to allow companies listed on Bursa Malaysia to disclose ESG data using a global standard based on the Task Force on Climate-Related Financial Disclosures recommendations. The platform also is intended to “accelerate swift adoption” of issuers’ “supply chain’s carbon emissions” (including based on data from non-listed organizations) and “help banks develop green financing products and services.” Educational and training on the Platform will begin in July of this year, with mandatory disclosure requirements starting in March 2024.

Industry reports indicate that Malaysia was already one of the more active jurisdictions in promoting ESG-related disclosures in the Asia Pacific region. A 2022 **PwC report** notes that Malaysia was one of the countries in the region with a “higher percentage of companies disclosing material factors from both internal and external stakeholders,” and that Malaysia was among the few countries that “stand out for disclosures of boards’ responsibilities and companies’ ESG governance structures.”

Taking the Temperature: Regulators and stock exchanges in the Asia-Pacific region increasingly are implementing ESG-related rules and guidance. For instance, Singapore recently launched the final consultation period to finalize a Green and Transition Taxonomy, Japan’s Financial Services Agency published a Code of Conduct for ESG Evaluation and Data Providers, and the IFRS Foundation announced the execution of a memorandum of understanding with the Ministry of Finance in China to establish a Beijing office.

Nonetheless, few jurisdictions in the region have implemented mandatory reporting on climate-related issues in a way that is comparable to incoming requirements in the EU. The European Sustainability Reporting Standards that are part of Europe’s Corporate Sustainability Reporting Directive will enter into force in 2024. As we have outlined previously, this will substantially increase the number of companies subject to the enhanced disclosure requirements. It remains to be seen whether or when countries in the Asia-Pacific region will adopt similar comprehensive ESG-related reporting requirements.

European Commission Aims to Tackle Greenwashing in Latest Proposal

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On March 22, 2023, the European Commission unveiled a proposal, the **Green Claims Directive**, (Proposal) aimed at combating greenwashing and misleading environmental claims. By virtue of the Proposal, the EC is attempting to implement measures designed to provide "reliable, comparable and verifiable information" to consumers, with the overall high-level goal to create a level playing field in the EU, wherein companies that make a genuine effort to improve their environmental sustainability can be easily recognized and rewarded by consumers. The Proposal follows a **2020 sweep** that found nearly half of environmental claims examined in the EU may be false or deceptive. Following the ordinary legislative procedure, the Proposal will now be subject to the approval of the European Parliament and the Council. There is no set date for entry into force at this time.

The Proposal complements a **March 2022 proposal** to amend the Consumer Rights Directive to provide consumers with information on products' durability and repairability, as well as to amend the Unfair Commercial Practices Directive by, among other things, banning "generic, vague environmental claims" and "displaying a voluntary sustainability label which was not based on a third-party verification scheme or established by public authorities." The Proposal builds on these measures to provide "more specific requirements on unregulated claims, be it for specific product groups, specific sectors or for specific environmental impacts or aspects." It would require companies that make "green claims to respect minimum standards on how they substantiate and communicate those claims." Businesses based outside the EU that make environmental claims directed at EU consumers will also have to respect the requirements set out in the Proposal. The criteria target explicit claims, such as "T-shirt made of recycled plastic bottles" and "packaging made of 30% recycled plastic."

Pursuant to Article 3 of the Proposal, "environmental claims shall be based on an assessment that meets the selected minimum criteria to prevent claims from being misleading," including, among other things, that the claim "relies on recognised scientific evidence and state of the art technical knowledge," considers "all significant aspects and impacts to assess the performance," demonstrates whether the claim is accurate for the whole product or only parts of it, provides information on whether the product performs better than "common practice," identifies any negative impacts resulting from positive product achievements, and reports greenhouse gas offsets.

Article 4 of the Proposal outlines requirements for comparative claims related to environmental impacts, including disclosure of equivalent data for assessments, use of consistent assumptions for comparisons and use of data sourced in an equivalent manner. The level of substantiation needed will vary based on the type of claim, but all assessments should consider the product's life-cycle to identify relevant impacts.

Pursuant to Article 10, all environmental claims and labels must be verified and certified by a third-party verifier before being used in commercial communications. An officially accredited body will carry out the verification process and issue a certificate of conformity, which will be recognized across the EU and shared among Member States via the Internal Market Information System. The verifier is required to be an officially accredited, independent body with the necessary expertise, equipment, and infrastructure to carry out the verifications and maintain professional secrecy.

Taking the Temperature: The Proposal is part of a broader trend of governmental regulators, self-regulatory organizations, and standard setters across industries adopting a more formalized approach toward greenwashing. For example, as we recently reported, the UK's Advertising Standards Authority (ASA) published rules on making carbon neutral and net-zero claims. Instances of enforcement actions over greenwashing allegations have also been on the rise. The Securities and Exchange Board of India recently launched a consultation paper seeking public comment on rules to prevent greenwashing by ESG investment funds, and the European Council and the European Parliament reached an agreement regarding European Green Bonds Standards aimed at, among other things, avoiding greenwashing.