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Basel Committee Issues Guidance on Core Principles for Effective Banking Supervision

August 8, 2023

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In April 2022, the Basel Committee on Banking Supervision (the Basel Committee) began a review of "the core principles for effective banking supervision" (Core Principles or CP). Last month, the Basel Committee published a **Consultative Document** on the Core Principles following its review.

The Basel Committee is the primary global standard setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. Its 45 members comprise central banks and bank supervisors from 28 jurisdictions. The Core Principles are an important component of the Basel Committee's global standards, aimed at ensuring sound prudential regulation and supervision of banks worldwide and are intended to remain a "living" standard, evolving over time in response to global financial developments, emerging risks, and changes in the regulatory landscape. The current review and update includes a consideration of supervisory and regulatory developments since the last substantive update in 2012.

The current review has been informed by several themes, including climate-related financial risks and risk management practices. The Consultative Document makes clear that climate-related financial risks can affect the safety and soundness of banks while also affecting the financial stability of banking systems as a whole.

To address these "new" risks, targeted changes have been introduced to the Core Principles to specifically address climate-related financial risks and promote a principles-based approach to supervisory practices and risk management. Proposed revisions to the Core Principles include the following:

- amendments to CP8 *Supervisory approach* and CP10 *Supervisory reporting*: supervisors would be required to consider climate-related financial risks as part of their supervisory methodologies and processes, and banks would be required to provide information to enable regulators to assess climate-related financial risks;
- adjustments to CP15 *Risk management process*: banks would be required to adopt comprehensive risk management policies and processes for climate-related financial risks that take into account the impact of different and varying time horizons, and implement appropriate risk management measures;
- adjustments to CP26 *Internal control and audit*: this would require the consideration of climate-related financial risks as part of a bank's internal control framework;

- amendments to CP14 *Corporate governance*: these amendments give greater emphasis to corporate culture and values and emphasize diversity and inclusion on bank boards;
- amendments to CP15 *Risk management process*: proposes the introduction of the concept of business model sustainability, with the key components of business model sustainability set out in CP8 *Supervisory approach*; and
- revisions to CP25 *Operational risk and operational resilience*: these reflect the importance of resilience to operational risk-related events (including pandemics and natural disasters) and include an emphasis on risk-related mapping interconnections and interdependencies.

The Basel Committee is seeking the views of stakeholders on the revised Core Principles and comments should be submitted by October 6, 2023.

Taking the Temperature: The Basel Committee's Consultative Document proposes certain key adjustments that have been informed by climate-related financial risks. The proposal recognizes the need for different, more comprehensive risk management policies and processes that take into account that climate-related financial risk may materialize and/or have impacts over varying time horizons, potentially beyond current capital planning. While supervisors have long emphasized the potential impact of climate-related risk on the financial stability of the banking system, the Consultative Document recommends that targeted, specific amendments and adjustments be implemented to address climate-related financial risks. We have previously reported on Basel III Pillar 3 requirements, which have as a key objective enhancing a focus on ESG-related risks within the bank prudential regulatory framework. In particular, Pillar 3 requires a variety of ESG-related disclosures, including qualitative and quantitative information on transition and physical risks, exposure to at-risk sectors and green lending. More recently, we also have discussed a European Central Bank assessment from April finding that banks, on the whole, are unprepared to comply with the European Banking Authority's (EBA) imminent Implementing Technical Standards (ITS) on Basel III Pillar 3 ESG risks.

Statement from the UN Environment Programme on the Net-Zero Insurance Alliance Reports on Target Progress

August 8, 2023

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On July 5, the UN Environment Programme (UNEP) **released a statement** on the Net-Zero Insurance Alliance's (NZIA) progress towards net-zero targets. The NZIA is convened by the **UN Principles for Sustainable Insurance (PSI)** and aims to decarbonize insurance and reinsurance underwriting portfolios in order to advance the transition to a net-zero economy. The commitment signed by NZIA members is accredited by the **UN Race to Zero** and the Alliance is a member of the **Glasgow Financial Alliance for Net Zero (GFANZ)**.

Since its launch two years ago, NZIA has worked to develop foundational concepts and frameworks to support its member companies in their efforts to achieve net-zero emissions. These include the **NZIA statement of commitment**, the **NZIA white paper on net-zero insurance**, the **PCAF Insurance-Associated Emissions Standard**, and the **NZIA Target-Setting Protocol**.

The Race to Net-Zero

The UNEP statement confirms that going forward, NZIA members are not required to set or publish any net-zero targets. Each member is responsible for and also publicly accountable for any net-zero targets, the roadmap created to achieve those targets, relevant methodologies adopted for this purpose, and measuring and monitoring progress toward net-zero commitments. Members independently determine their own path to net-zero with the NZIA providing support, including best practices, "to aid in the accurate measurement, standardization, and comparability of science-based decarbonization targets for insurance and reinsurance underwriting portfolios and to enhance overall transparency and accountability across the insurance industry on climate action." The statement emphasizes that NZIA membership does not involve any "coordinated competitive conduct or exchanges of competitively sensitive information." While the protocol is specifically designed for NZIA members, UNEP encourages all insurance market participants, whether NZIA members or not, to utilize it and the methodologies set out to align with any proposed net-zero transition pathway.

Taking the Temperature: Although not stated expressly, the UN Environment Programme's statement may represent at least in part a reaction to NZIA membership

losses. As we have discussed, Munich Re, Zurich and Hannover Re, three major insurance providers, announced their exit from the NZIA in the span of one month between March and April 2023. Other departures have followed. Munich Re cited "material antitrust risks" as the reason for withdrawing. On May 15, 2023, twenty-three Republican state attorneys general (AGs) sent a letter to members of the NZIA expressing "serious concerns" about whether the NZIA's requirements comply with federal and state laws, and demanding certain information. At the same time, as they grapple with the politicized nature of ESG in the U.S., insurers also are dealing with business risks associated with climate change. We have reported on the findings in Goldman Sachs Asset Management's 12th annual insurance survey, where just over one-third of insurance executives surveyed stated that climate change could also affect their ability to insure for extreme weather events. Likewise, an Allianz report cited as risks for carriers increasing climate-focused litigation against companies and their boards, noting that "the cumulative number of climate change-related litigation cases has more than doubled since 2015." Particular types of cases cited included those asserting claims for greenwashing, failure to comply with international agreements such as the Paris Agreement, and claims based on companies making insufficient progress toward articulated sustainability targets. Reflecting these challenges, insurance industry groups in addition to NZIA and regulators have offered support and guidance. For instance, we have discussed the Association of British Insurers publishing guidance (the Action on Nature Guide) setting out what insurers and long-term savings providers can do to help prevent biodiversity loss in the UK and become more "nature positive." Recognizing the challenge that many businesses face when trying to assess their impact or reliance on nature, the ABI produced the Action on Nature Guide to assist its member firms to better understand the issues policyholders are facing and how they can protect themselves from the risks associated with nature and biodiversity loss.

UNFCCC Introduces Framework for Assessing Non-State Parties' Net-Zero Progress

August 8, 2023

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The United Nations Framework Convention on Climate Change (UNFCCC) has introduced the **Recognition and Accountability Framework** to recognize voluntary climate change pledges by non-state actors and ensure greater transparency and accountability regarding those commitments. The UNFCCC presented the Framework at the June 2023 **Climate Change Conference** in Bonn, Germany. The Framework has been designed as a means for holding organizations accountable for their commitments to the Paris Agreement rather than for purposes of monitoring or sanctioning.

The Framework sets out "specific objectives, deliverables and timelines to enhance the recognition and accountability of climate action pledges, plans, and reporting" for non-state parties via the **UNFCCC's Global Climate Action Portal (GCAP)**. How the Framework addresses the recognition and accountability of individual non-state actors will be addressed in individual company implementation plans. Generally, it sets out a number of principles related to commitments, governance and data management.

The principles set out in the Framework have been designed to integrate with other UNFCCC initiatives focused on practical implementation. At COP26, the UN announced the convening of a High-Level Expert Group (HLEG) on Net Zero Emissions Commitments of Non-State Entities, which sought to improve the credibility of net zero commitments. HLEG subsequently made ten recommendations in its **Integrity Matters** report at COP27 setting out how stakeholders can improve the quality, integrity and credibility of net zero commitments, transition plans and monitor progress. Following this, the UNFCCC has developed a **Draft Implementation Plan**, outlining how stakeholders can operationalize HLEG's recommendations. According to the Draft Implementation Plan, the plans of non-state parties must incorporate the Framework's principles to provide assurance to parties and the public regarding:

- the integrity of voluntary commitments and their contribution to the aim of the Paris Agreement;
- credibility, leadership and recognition of progress toward commitments made by non-party stakeholders;

- identification of systemic barriers faced by non-party stakeholders in undertaking climate action; and
- transparency regarding the systemic impact of those that have not taken or are not delivering on their voluntary climate commitments.

Among various deadlines, recommendations on the consistency of third-party verified emissions data — and approaches to accreditation of verifiers themselves — are due in November 2023. Further details are expected to be announced at the Conference of the Parties of the UNFCCC, known as COP28, in late November 2023.

Taking the Temperature: The UNFCCC's Framework builds on last year's COP27 Integrity Matters report. The proposed Framework pushes Integrity Matters further by focusing on the data management aspect of non-parties' voluntary commitments, with an eye towards ensuring they are aligned with parties' Paris Agreement commitments. The Framework suggests that an important area of discussions at COP28 will focus on authentication protocols, accuracy checks, comparability requirements, secure infrastructure, and open data.

The accuracy of data and the assessment of that data are areas of focus in the Framework. Voluntary pledges by non-party stakeholders will be recognized "on the UNFCCC Global Climate Action Portal (GCAP) as the United Nation's data access point for all non-Party stakeholder voluntary climate action commitments." However, the UNFCCC is taking steps to "ensure that data and information received or disseminated by GCAP" will be the result of "processes and systems" that, among other things, seek to ensure that data is: (i) authentic; (ii) validated "by data providers directly;" (iii) comparable, with "an aim for interoperability and harmonization, comparable datasets sent by data providers or directly to GCAP are recommended;" (iv) secure, where collaborations "on digital infrastructure should enable ease of data sharing with GCAP" and promote data security; and (v) accessible and searchable through visual dashboards or downloads. In this way, the Framework apparently is seeking to address the existing situation, whereby, as we have reported, there is broad regulatory and industry consensus regarding the lack of quality, consistent, and reliable climate-related data.

UK Regulator Raises Concerns over the Sustainability-Linked Loans Market, Including Potential Greenwashing

August 8, 2023

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On June 29, 2023, the Financial Conduct Authority, the UK's financial markets regulator, released a summary of its concerns over the market for sustainability-linked loans (SLLs). Responding to concerns that banks overstate the extent to which they participate in green financing or otherwise have a positive ESG impact, in May 2023 the FCA began conducting interviews with banks and borrowers about the transparency of ESG-related loans. Following completion of engagement with stakeholders, the FCA **published a letter** addressed to the heads of ESG/Sustainable Finance at certain banks and companies, in which it raised concerns regarding SLLs, including potential greenwashing.

SLLs are loans that incentivize borrowers to achieve pre-determined ESG-related targets, principally by linking the interest rate margin of the loan to ESG-related targets: when borrowers do not meet their stated goals, they pay higher interest rates. SLLs are part of a broader market for sustainable debt, which can also include green bonds, green loans, sustainability-linked bonds (SLBs), sustainability bonds, and social bonds. SLLs are different from "green loans" in that they can be utilized for general commercial purposes and need not be used to finance green assets or projects, provided businesses meet the sustainability targets mandated in the loan documents.

The FCA probe focused on whether these loan transactions have "low quality" sustainability clauses—that is, whether the sustainability targets are intentionally easy to meet. In some cases, sustainability targets for financings are not made public, in contrast to public corporate ESG goals. Another area of concern for the FCA is so-called "sleeping" SLLs—loans that are identified as SLLs before any sustainability-related targets have been defined or go into effect. In other words, the loans are labelled as SLLs and may have some core elements of the SLL structure including potential interest rate adjustment, but do not define, at least at origination, the sustainability performance targets. While the parties may memorialize the intention to agree on the performance targets at some point, having this intention in the initial agreement is not sufficient to classify the instrument as an SLL, according to principles and guidance issued by the Loan Market Association (LMA), the Loan Syndications and Trading Association (LSTA) and the Asia Pacific Loan Market Association (APLMA).

The FCA raised two principal areas of concern in its letter:

1. **Credibility, market integrity and greenwashing concerns**
   One of the primary concerns with SLLs is the possibility of greenwashing. In the context of SLLs, the FCA expressed concern that borrowers could manipulate their ESG-related goals, i.e., the sustainable performance targets (SPTs) and key performance indicators (KPIs) of the loan, to project a positive image, without genuine efforts to achieve meaningful sustainability outcomes (possibly by setting targets that are too easily met). The FCA points out that concerns from market intelligence received in early 2023 includes suggestions of "low ambition and poor design in some SLLs."

   To address greenwashing risk, the FCA is advising that borrowers should align their SPTs and KPIs with their published climate transition plans. To the extent a company has adopted one, such as those proposed by the Transition Plan Taskforce framework, these plans serve as comprehensive roadmaps outlining a company's journey toward sustainability. By closely linking SPTs and KPIs to these tangible plans, borrowers can demonstrate their commitment to sustainable practices, building credibility among investors and stakeholders.

2. **Conflicts of interest and weak incentives to issue SLLs**
   Despite the potential benefits of SLLs, the FCA observed that some borrowers might find the incentives to issue SLLs inadequate. Small savings on margins may be overshadowed by the costs and negotiation time with lenders, especially for smaller firms. Additionally, the fear of scrutiny over specifying SPTs and KPIs may discourage borrowers from embracing sustainability-linked financing. On the other hand, banks may prioritize relationships over a borrower's sustainability credentials, potentially affecting the decision to participate in SLLs. Additionally, the SLL Principles (SLLP) and related guidance (SLLP Guidance) issued by the LMA, LSTA and APLMA require annual external verification of a borrower's compliance with SPTs and KPIs, which is likely be a significant cost and time burden for mid-market borrowers.

Taking the Temperature: For companies and financial institutions alike, accusations of greenwashing are a mounting concern, from regulatory, litigation and reputational perspectives. The UK's FCA is not the only regulatory body concerned with combatting greenwashing in the sustainable finance market. In February, the LMA, LSTA and APLMA published updates to the SLLP and SLLP Guidance, and in May the LMA released model provisions for SLLs.

As we have reported previously, SLLs are one of the fastest growing segments of the sustainable finance market, with originations holding steady in 2022 in the U.S. and Europe, despite some market challenges. However, concerns around greenwashing, market integrity, and conflicting interests must be addressed to realize their true potential. Financial institutions and companies should consider the FCA's observations and incorporate them as applicable into their transition finance strategies. While the FCA is not yet regulating the SLLs market, it has been and will continue to monitor the sustainable finance market as part of its wider work of supporting the development of a robust transition finance ecosystem.

EU Parliament Adopts Stricter Measures to Safeguard Water Quality and Combat Pollution

August 8, 2023

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On June 27, the European Parliament **proposed amendments** to legislation aimed at reducing pollution in Europe's water bodies covering inland, transitional and coastal surface waters and groundwater, to better protect human health and natural ecosystems. This is part of the implementation of the **European Commission's Zero Pollution Action Plan**.

The proposed amendments to **Directive 2000/60/EC (the Water Framework Directive)**, **Directive 2006/118/EC (the Groundwater Directive)** and **Directive 2008/105/EC (the Environmental Quality Standards Directive)** are aimed at enhancing the existing legislative framework in the following ways :

- **A watch list of harmful chemicals must be established and maintained.** Members of the European Parliament (MEPs) advocated for an expansion of the "watch list" of substances posing a "significant risk to human health and the environment," requesting that the list be updated to keep pace new scientific evidence and chemicals. Currently 53 substances are covered in legislation addressing surface water, including pesticides, industrial chemicals and metals. The proposed amendments would add another 23 individual substances to this list, including microplastics, antimicrobial resistant microorganisms, selected antimicrobial resistance genes, and potentially sulfates, xanthates, and non-relevant pesticide metabolites.
- **Threshold values are to be ten-times lower for groundwater than for surface water.** PFAS (per- and polyfluoroalkyl substances), types of chemicals that resist grease, oil, water, and heat and do not break down in the environment, were detected in more than 70% of EU groundwater measuring points. MEPs called for a subset of PFAS and total concentration of PFAS to be included as groundwater pollutants. Further, MEPs called for threshold values applicable to groundwater to be "ten times lower" than those set for surface water.
- **Financial responsibility will be imposed upon polluters.** The financial burden of detecting and monitoring polluting chemicals is currently borne by the Member States. MEPs called on the Commission to consider establishing an "extended producer responsibility mechanism" to ensure that the producers of polluting products pay for the costs of detecting and monitoring such chemicals.

The new measures fall under the European Green Deal and were originally **proposed by the European Commission** in October 2022. Once the European Council adopts its position, consultations will begin with Member States to finalize the form of the amended law.

“Enhanced protection of EU waters is extremely important, especially in the context of the ever more pressing impacts of climate change - combined with industrial and agricultural pollution - on our fresh water resources,” said rapporteur Milan Brglez.

Taking the Temperature: As we reported previously, the EU Climate Law 2021 made the targets of the European Green Deal legally binding. EU legislators have since advanced their efforts to translate these obligations into tangible regulation that keep up-to-date with scientific developments relating to environmental damage and climate change. The proposed amendments tackling water pollution are in line with the European Green Deal's ambitious target of achieving zero pollution by 2050. The Zero Pollution Action Plan is one of a number of initiatives under the “Environment and Oceans” pillar of the European Green Deal. Other initiatives include the protection and expansion of CO2-absorbing natural ecosystems known as carbon sinks.