C A D W A L A D E R

# Hong Kong's Central Banking Institution Directs Banks to Ramp Up Net Zero Transition Planning

**October 17, 2023**

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The Hong Kong Monetary Authority (HKMA), Hong Kong's de facto central banking institution, **issued a directive** for banks setting out high-level principles on planning for a transition to a net-zero economy. In a "Dear CEO" letter dated August 29, 2023, to all authorized institutions, Daryl Ho, Executive Director of the Banking Policy Division, directed banks to integrate net zero transition into their planning activities by (i) aligning their objectives with net zero, and (ii) incorporating net zero into their internal processes. The HKMA stated that the new principles are geared towards helping banks maintain "safety and soundness in the transition."

The high-level principles set out in the letter are:

- **Setting clear objectives and targets:** These objections and targets can vary from institution to institution. For some, objectives might include development of a transition strategy, whereas others might focus on a risk management process. Targets need to be aligned with the 2015 Paris Agreement.
- **Establishing a robust governance framework and embedding transition considerations into internal processes:** This framework should go beyond basic corporate governance; while board and executive oversight are key, net-zero transition planning should factor into relevant strategies, business models, and the bank's products and services.
- **Operationalizing these objectives through appropriate initiatives and actions:** This principle is more relevant for institutions that have objectives that include a transition strategy, rather than simply transition risk management. When possible, banks should seek to establish quantifiable milestones.
- **Proactively engaging with clients:** Banks should actively support their clients in a net-zero transition, including by collecting relevant information on risks and opportunities across disparate sectors.
- **Undergoing reviews and making updates to transition plans accordingly:** Reviews should be frequent so that updates can be made to transition strategies in a timely manner.
- **Maintaining transparency:** Whenever possible, banks should seek to increase the transparency of their transition planning processes.

These high-level principles apply to all authorized institutions in Hong Kong, including those that are local subsidiaries or branches of foreign banks. HKMA noted that, while net-zero transition planning is generally conducted by the bank's head office, it is incumbent upon all foreign banks, including local branches, to take net-zero transition planning into account with respect to their activities in Hong Kong.

**Three-Phased Approach and Guiding Documents**

HKMA relied on several guiding documents and policies in its development of these high-level principles. This effort is part of HKMA's three-phased approach. Phase I featured the development of a common assessment framework. Phase II focused on supervisory requirements, and initial thoughts on the approach to addressing climate-related and broader sustainability issues. HKMA is now in Phase III, in which the HKMA is assessing banks' progress in satisfying supervisory requirements.

With the ongoing implementation of Phase III raising the bar on green and sustainable banking, HKMA has also reviewed the findings and recommendations of several international bodies in the formation of its net-zero transition high-level principles, including the Network of Central Banks and Supervisors for Greening the Financial System (NGFS)'s **"Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities"** (May 2023), the Glasgow Financial Alliance for Net Zero (GFANZ)'s **"Financial Institution Net-zero Transition Plans: Fundamentals, Recommendations, and Guidance"** (November 2022) and the Task Force on Climate-related Financial Disclosures' **"Guidance on Metrics, Targets and Transition Plans"** (October 2021).

**Taking the Temperature: As we have discussed at length, including recently here and here, financial regulators are increasingly focused on climate risk management, which has been a key HKMA supervisory focus since 2019. While it may seem that establishing high-level principles on the net-zero transition for HKMA's authorized institutions should have little downside, some commenters have observed that international standards are still in flux. The recent release of HKMA's principles typifies the issue in sustainable banking and the net-zero transition more broadly: stakeholders (and industry) seek clarity, and divergent standards pose challenges for institutions regulated in multiple jurisdictions. HKMA acknowledges that future updates might come from several sources, including The Basel Committee on Banking Supervision, which is the primary global standard setter for the prudential regulation of banks and whose guidance we have previously discussed. It is also likely that continued dialogue within the industry will prompt updates to HKMA's own guiding principles. Ultimately, HKMA's announcement is a continuation of the trend of frequent jurisdiction-specific updates to net-zero transition planning.**

# EFRAG and GRI Announce Interoperability in Impact Reporting Schemes

**October 17, 2023**

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The European Financial Reporting Advisory Group (EFRAG) and the Global Reporting Initiative (GRI) **released a joint statement** announcing the interoperability of their respective reporting standards, enabling companies subject to both reporting schemes to avoid having to report separately under both regimes. The hope is that this effort will make the sustainability reporting process easier on industry participants, more user-friendly, and reduce complexity and ambiguity.

The European Commission adopted EFRAG's European Sustainability Reporting Standards (ESRS) in July. The standards clarify the requirements for sustainability-related impact, opportunity and risk reporting under the EU's **Corporate Sustainable Reporting Directive (CSRD)**, which took effect in July of this year. The CSRD currently applies to 12,000 companies but, by early 2024, the number of companies required to provide sustainability disclosures will increase to more than 50,000.

The CSRD requires a double materiality approach, deepening the concept of materiality in sustainability reporting. A company must report not only on how its business is affected by sustainability issues (known as "outside in"), but also how its activities impact society and the environment (known as "inside out"). As the EFRAG-GRI statement explains, EFRAG has adopted the GRI's definition for impact materiality under the ESRS, acknowledging GRI's expertise in this area. The impact definitions, concepts and disclosures of the ESRS and the GRI are now intended to be closely aligned, except in cases in which full alignment is not possible due to the content of the CSRD mandate.

The ESRS also now permits businesses using GRI's standards to report on material topics covered by GRI standards and not by the ESRS (e.g., tax). In particular, the new ESRS 1 (§114) and ESRS 2 (§15) explicitly allow the inclusion of disclosures from other standards, such as the GRI, in ESRS sustainability statements.

With this key update, businesses can now comply with both ESRS and GRI standards in a single report, substantially lessening the disclosure burden for businesses that resulted from two separate sets of standards.

**Taking the Temperature: As we discussed in a prior article, the reporting standards developed by EFRAG were much anticipated and generally speaking, viewed as a major step forward in terms of providing actionable guidance with respect to sustainability reporting. Among the criticisms of the ESRS, however, was the need to improve its "interoperability" with other international standards and provide additional specific guidance on materiality assessments. Reconciling these two frameworks addresses both of these critical issues.**

**The interoperability of these two reporting schemes is reflective of a general trend: there increasingly has been a more intense effort to reduce complexity and redundancy in reporting. A key part of this is the development of more sector-agnostic standards, which the EU has already acknowledged as a priority, as we previously discussed.**

# Structured Finance Industry Group Publishes ESG Best Practices for Auto ABS and RMBS Disclosures

**October 17, 2023**

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In September 2023, the Structured Finance Association (SFA) published its **ESG Best Practices for Auto Asset-Backed Securities (ABS) and Residential Mortgage-Backed Securities (RMBS) Disclosures**. The industry-wide working group spearheaded the development of principles-based approaches for securitization disclosures, reflecting consensus-based views from issuers, investors, rating agencies, data & analytics firms, and other securitization transaction parties. The SFA has been working on its ESG Disclosures Initiative to develop best practices for reporting decision-relevant ESG metrics across various asset classes since May 2022.

**Industry-Wide Disclosures Principles**

The SFA assessed existing environmental disclosures in Agency and non-Agency RMBS and ABS markets, and against established global environmental frameworks such as the UN Principles for Responsible Investment (PRI), Partnership for Carbon Accounting Financials (PCAF), International Capital Markets Association (ICMA), Sustainability Accounting Standards Board (SASB), and Task Force on Climate-Related Financial Disclosures (TCFD). Based on this analysis, the group **established a principles-based approach** (the "Principles") whereby securitization disclosures should meet the following criteria:

- Relevant
- Objective
- Verifiable
- Measurable
- Comparable
- Accurate

These Principles aim to ensure uniformity, credibility, and transparency in ESG disclosures.

**Asset Class—RMBS**

In the RMBS Working Group, two broad categories, Energy Efficiency and Physical Risk, were identified as areas where the market could adopt disclosure best practices in the short term (Phase I) based on currently available standardized data. Metrics considered for disclosure within RMBS include:

- Home Energy Rating System (HERS) Score: Recommended for disclosure if HERS rating is a material criterion of a Green Bond program. Disclosure should cover the number of loans in the pool with HERS ratings and the HERS rating threshold within a Green Bond program.
- Green Building Certificates (GBC): Recommended for disclosure if GBC is a material criterion of a Green Bond program. Disclosure should cover the number of loans in the pool with certified GBCs, details of each certified GBC, and the methodology for approving GBCs.
- Green Mortgage Programs: Disclosure should follow program offering documents and adapt to programmatic changes.

Phase II considerations may include Physical Risk disclosures, particularly FEMA-derived data, dependent on market dynamics and member interest.

**Asset Class—Auto ABS**

In the Auto ABS Working Group, Clean Transportation was identified as an area for short-term (Phase I) disclosure. Specifically, the Concentration of Vehicle Propulsion Systems was identified as a disclosure metric that meets the Principles. This metric involves reporting the types of propulsion systems (Electric, Hybrid, Internal Combustion, Other) for each vehicle within the pool, presented in a stratification table in the prospectus document.

Additional disclosure fields, such as EPA GHG Score, EPA Average Tailpipe Emissions, EPA Vehicle Fuel Efficiency, and EPA Smog Rating, were considered, but concerns were raised about data availability and accuracy in the context of securitization disclosures.

The suggested implementation date for the Auto ESG disclosure metric is January 1, 2024, allowing issuers time to make necessary updates. Phase II disclosures will be considered based on member interest and market and regulatory dynamics.

**Taking the Temperature: The SFA ESG Disclosure Initiative has produced proposed best practices for ESG disclosures within certain asset classes within the structured finance market, with a focus on environmental disclosures. Although the degree to which market participants will adopt the new best practices remains to be seen, the structured finance industry has been a focus of increasing disclosure guidance. As we reported earlier this year, the European Supervisory Authorities (ESAs) and the European Central Bank (ECB), published a Joint Statement on climate-related disclosure for structured finance products. In describing the need for such guidance, the ESAs and ECB stated that "securitisation transactions are often backed by assets that could be directly exposed to physical or transition climate-related risks, such as real estate mortgages or auto loans. Since the value of these underlying assets could be affected by climate-related events, the ESAs and the ECB share the view that the reporting on existing climate-related metrics needs to improve, and that additional metrics are necessary. Additional climate-related data will allow investors to better identify climate change-related risks while avoiding overreliance on estimates from external sources." We also previously reported**

**on the importance of securitization transactions to securing a portion of the massive financing necessary to fund efforts to transition to a green economy.**

# Governor Newsom Signs Twin Climate Disclosure Bills Into Law

**October 17, 2023**

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On October 7, 2023, Governor Newsom passed Senate Bills 253 and 261 into law, which significantly expand California companies' disclosure requirements concerning greenhouse gas emissions and climate-related financial risks.

Last month, **we covered Senate Bill 253** (California Climate Corporate Data Accountability Act), which mandates the disclosure of carbon emissions Scope 1 and 2 emissions beginning in 2026, and Scope 3 emissions beginning in 2027.

**Senate Bill 261** (Greenhouse Gases: Climate-Relate Financial Risk) requires California companies with revenues in excess of $500 million to file biannual disclosures pertaining to financial risks resulting from climate change. First, companies covered under the legislation are required to prepare a climate-related financial risk report beginning after January 1, 2026, disclosing the "material risk of harm to immediate and long-term financial outcomes due to physical and transition risks" in accordance with the recommended framework in the **Final Report of Recommendations** published by the Task Force on Climate-Related Financial Disclosures, or an equivalent set of climate reporting guidelines. Second, a covered company must also disclose any measures it has undertaken to "reduce and adapt" to the climate-related financial risks it disclosed in its report.

SB 261 exempts subsidiaries from preparing an independent report so long as the parent company prepares a consolidated disclosure encompassing its subsidiary entities. Additionally, the climate-risk disclosures are required to be made available to the public on the company's website. Companies are also required to pay a yet undetermined fee upon filing the report for the administration and costs of implementing the SB 261 requirements. Failure to comply with the reporting requirements could result in a penalty of up to $50,000 per year.

**Taking the Temperature: California continues to take the lead in the United States in the push for transparency and disclosures related to carbon emissions and climate risks, and this legislation may serve as a model for other states to implement their own similar disclosure requirements. As we have previously discussed, many large companies are likely already collecting and preparing to report (or actually reporting on) these metrics, consistent with regulations in Europe and Asia and the SEC's proposed regulation. For others, the new legislation may require additional, and potentially significant, resources to ensure compliance when the reporting requirements take effect in January 2026.**

**However, the implementation and enforcement of this legislation is likely to continue to take shape over the next few years as companies and government officials prepare for the legislation to take effect.**

# UK's Pensions Regulator Pushes for Further Climate Scenario Analysis

**October 17, 2023**

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In August 2023, the UK pensions regulator's climate and sustainability lead, Mark Hill, **authored an article** setting out how trustees can improve the climate-scenario analyses used by their schemes, in order to make them more "decision-useful." While Hill acknowledged that the sector had made progress on its climate journey, "data and analytical gaps and imperfect models seem to present considerable challenges."

Earlier this year, The Pensions Regulator's (TPR) Executive Director **raised concerns over the integrity of some climate scenarios** and warned in-scope schemes that enforcement action may be taken against them for failure to comply with TPR's requirements to, among other things, publish a statement of investment principles (SIP). A scheme's SIP should set out its investment policy and include considerations of financially material ESG factors including, but not limited to, climate change.

In his piece, Hill stated that since Parish voiced the TPR's concerns in April, the regulator had seen schemes' climate scenarios drawn further into question in media articles and in a report by the Institute and Faculty of Actuaries entitled **"The Emperor's New Climate Scenarios,"** which highlights the drawbacks of current models and scenario analysis, and casts doubt on the validity of some published outcomes. Addressing those reports, Hill said "[t]hey rightly question the validity of some published outcomes, which appear to seriously underestimate the financial risk from climate change and are at odds with the established earth and climate science."

Hill considered how trustees can help drive the change required in climate scenario analyses and outlined TPR's expectations of trustees:

- have an appropriate level of knowledge and understanding of climate issues;
- undertake regular training and ask for additional training if required;
- regularly review climate-related capabilities of service providers and consider whether there is a need for additional or specialist advisers;
- be able to understand the narratives underlying climate scenarios, the limitations of those scenarios and the assumptions made in their constructions;

- broadly rationalize the outputs from those scenarios for their scheme; and
- consider with advisers the use of stress testing and tail risk analysis to complement their climate scenario input to investment strategy decision making.

In closing, Hill stated that one of TPR's aims as part of its climate change strategy was to influence debates around pensions and climate change. The regulator will continue to encourage more debate ahead of the Department of Work and Pensions' (DWP) review of the TCFD recommendations, when it will consider whether the UK's Climate Change Governance and Reporting Regulations ought to be amended so as to encompass the TCFD recommendations.

**Taking the Temperature: This latest call by TPR for schemes to improve the way they analyze potential ESG risks and opportunities is by no means the first. In May 2023, TPR undertook a review of the disclosures published by more than 71 UK pensions schemes and highlighted several areas for improvement, including that disclosures of strategy and scenario analysis did not always satisfy guidance issued by the DWP. We have also discussed TPR's intention to tighten regulation around ESG data published by trustees.**