Climate disclosures: A global risk driver in financial lines

UK | Europe | Asia Pacific | USA | Latin America and the Caribbean

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Kennedys

Introduction

COP26 brought global communities together to accelerate action towards the goals of the Paris Agreement and the UN Framework Convention on Climate Change. However, the focus of the November 2021 conference was not solely government climate pledges; the spotlight was very much on the global private sector in terms of net-zero commitments as well.

Global investment and commitment to climate change has therefore never been so significant for corporates, their boards, and in turn their financial lines insurers.

What COP26 reinforced was that climate change is a global issue and can only be truly tackled successfully if a unified approach is taken by all global stakeholders. With mandatory climate disclosures becoming law in the UK (effective from 6 April 2022) and the United States Securities & Exchange Commission (SEC) announcing its long awaited climate disclosure rule on 21 March 2022, this report provides a snapshot of the approach towards climate disclosures in some of the jurisdictions in which Kennedys operates, before focusing on what this means for our policyholder and insurer clients in the financial lines arena.

United Kingdom

From 6 April 2022, it has become mandatory for Britain's largest businesses to disclose climate related financial information in line with recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD). In doing so, the UK has become the first G20 country to make it mandatory for its largest companies and financial institutions to report on climate-related risks and opportunities. This will include many of the UK's largest traded companies, banks and insurers, as well as private companies with over 500 employees and £500 million in turnover.

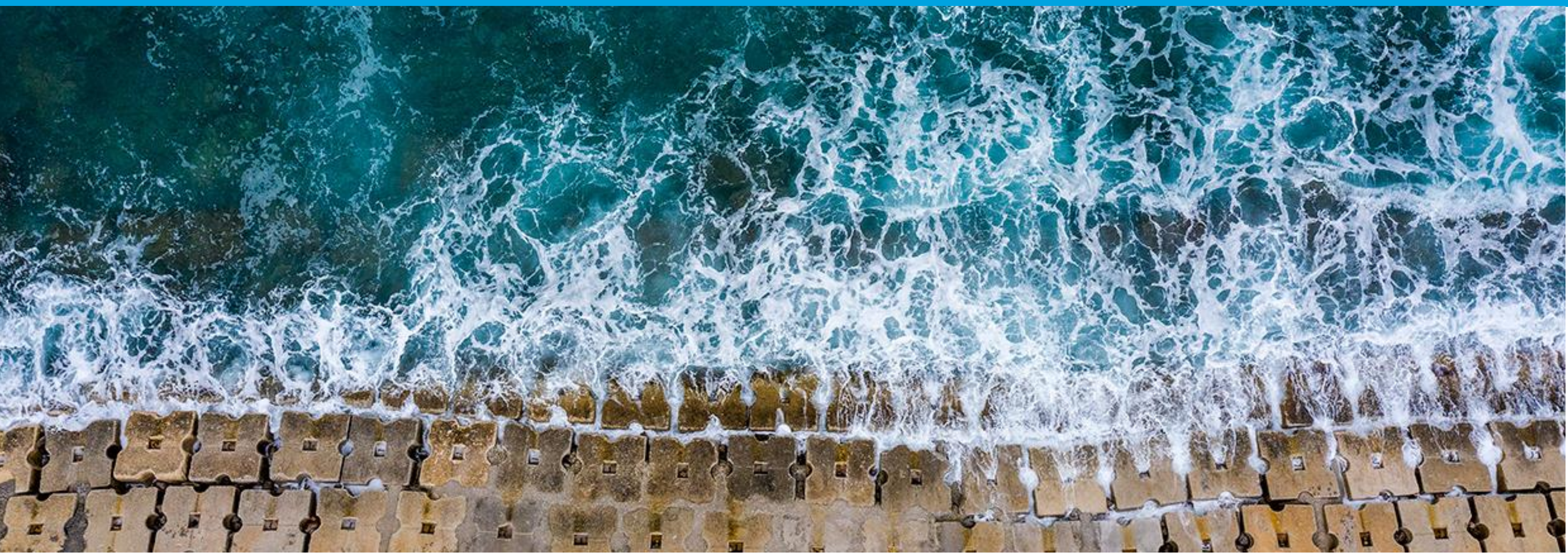
Climate related reporting is not a new phenomenon. The TCFD has been working with investors to understand and voluntarily report on their financial exposure to climate risk since COP21 in 2015. As part of the UK Government's commitment to reducing greenhouse gas emissions by at least 100% of 1990 levels (net zero) by 2050, the Government consulted on the proposal to introduce mandatory TCFD-aligned climate related financial disclosures in March 2021.

The TCFD subsequently outlined its recommendations in the Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2021, which was laid down before the UK Parliament on 28 October 2021. Fundamentally, ahead of COP26, the UK Government announced its intention to introduce mandatory disclosures from April 2022, with the intention of expanding these across the economy by 2025.

The UK Government's intention behind mandatory disclosures is to assist businesses (as well as their investors and directors/officers) to "better understand the financial impacts of their exposure to climate change, and price climate-related risks more accurately, while supporting the greening of the UK economy".

A common set of requirements aligned with TCFD recommendations should help parties consider how corporates and their board are working towards the UK's transition to net zero (albeit care should be taken given the range of sectors and industries affected).

However, this new reality of mandatory disclosure coupled with the enhanced focus on businesses' commitment to climate change in any event (including from investors, the media and the general public) inevitably creates an area of risk and exposure.



The London School of Economics reported 73 examples of climate change litigation in the UK as of July 2021. However, this was well in advance of COP26 kick starting this renewed focus on climate action in the UK and before these new mandatory disclosures will be in place.

Therefore as we come to below, climate change disclosure and its impact is an area that corporates, directors and their financial lines insurers need to prioritise and carefully account for.

The EU Green Deal

The EU Green Deal is a growth strategy of the EU to promote ambitious environmental, climate and energy policies in order to boost sustainability. Presented in December 2019, it is comprised of a set of policy initiatives by the European Commission, with the aim of achieving carbon neutrality in the EU by 2050.

Specific legislative instruments implemented by the European Commission in this area include the Sustainable Finance Disclosure Regulation (SFRD) (Regulation (EU) 2019/2088) and the Taxonomy Regulation (Regulation (EU) 2020/852).

> **The SFRD sets out how financial institutions within the EU must inform their customers about sustainable investments and sustainability risks, namely, how they integrate environmental, social and governance issues (ESG) into their risk processes both pre-contract and in reporting to investors.**

The SFDR will apply from 1 January 2023, with financial market participants having to disclose principal adverse impacts (PAIs) and the sustainability features of their financial products for the first time by 30 June 2023. That first PAI disclosure would need to cover the first reference period under the RTS (1 January 2022 to 31 December 2022).

The Taxonomy Regulation establishes a framework and is a classification tool of sustainable investments. The purpose of the framework is to make it easier to determine whether an investment is environmentally sustainable based on six environmental goals. Reporting under the EU Taxonomy Regulation is mandatory for financial and non-financial companies such as large public-interest companies (including companies listed on regulated markets, banks and insurance companies) with more than 500 employees.

European authorities are currently in the process of drafting a new Corporate Sustainability Reporting Directive (CSRD), which will amend existing reporting requirements under the Non-Financial Reporting Directive, extend the law’s scope to all large companies and companies listed on regulated markets, and introduce more detailed reporting requirements.

> **The CSRD mandatory standards are due to be published in October 2022 and should be aligned with the following financial year.**

However, publication of reports by large companies are not expected until 2024. European SMEs, meanwhile, will have another three years to prepare for the regulation and won't be required to publish their reports until 2026.

What this means is:

- In 2022, non-financial undertakings need only disclose the proportion of EU Taxonomy-eligible and EU Taxonomy non-eligible economic activities in their total turnover, capital and operational expenditure, and qualitative information accompanying the key performance indicators. As of January 2023, non-financial entities will be obliged to report eligibility and alignment. The full reporting requirements will apply from this date.
- On the other hand, financial institutions (for which the transition period is longer and reporting required in both 2022 and 2023) need to disclose only EU Taxonomy-eligibility.
- From January 2024, financial entities will be obliged to report both taxonomy eligibility and alignment. The full scope of mandatory reporting for financial entities will start in January 2026.

Ireland

Ireland's financial regulator, the Central Bank of Ireland (CBI), expects the financial services sector in Ireland to implement the EU Green Deal and encourage greater investment in greener securities. Reference is made to the CBI's Securities Markets Risk Outlook report, dated February 2022.

In November 2021, the CBI wrote to all regulated financial service providers setting out its supervisory expectations on climate change and sustainability in five key areas:

- **Governance:** boards need to demonstrate clear ownership of climate risks affecting them, and promote a culture that emphasises climate and other ESG issues.
- **Risk management framework**: firms need to show an understanding of the impact of climate change on the risk profile of the firm, and strengthen their existing risk management frameworks to ensure such risks are addressed.
- **Scenario analysis**: the CBI advises that scenario analysis and stress testing are critically important for firms to assess the impact of future climate outcomes.
- **Strategy and business model risk:** the CBI also expects firms to undertake business model analysis to determine the impacts of climate change on the firm's overall risk profile, business strategy and sustainability, and to inform strategic planning.
- **Disclosures:** firms must adhere to the transparency and disclosure principles and requirements, including the Taxonomy Regulation and the SFDR.

As noted above, the Taxonomy Regulation requires financial product providers to be transparent in their pre-contractual disclosures and in periodic reports regarding the environmental sustainability of their investment, their environmental objectives, climate change mitigation and climate change adaptation.

The CBI has stated that the existing legal requirements make clear that firms are to avoid 'greenwashing'.

Whilst the CBI's expectations are not legally binding, it has indicated that they will be applied in a proportionate manner depending on the nature, scale and complexity of the entity. Regulated businesses and their boards will therefore come under inevitable increased scrutiny as to how they manage climate change risks, communicate their environmental credentials to investors, and their compliance with the Taxonomy Regulation and the SFDR.

Such scrutiny could lead to guidance letters being issued by the CBI requiring a business to change its practices to as to meet the expectations, and further transgression of such guidance could lead to enforcement actions against transgressor firms (and their directors/officers) for failure to comply with disclosure obligations.

There is also the potential for 'mis-selling' type claims from investors arising from alleged failure to comply with these obligations. All of which will be of great concern to corporates, their boards and their financial lines insurers.

Spain

In May 2021, Spain implemented the Climate Change and Energy Transitions Act, which provides regulations for disclosure on climate and environmental data for financial institutions (including insurance and reinsurance companies).

The Act also calls for the mandatory issuance of an annual report to include assessment on the financial impact of climate risks generated by the institution's business model and details of remedial measures taken for dealing with such risks.

At this preliminary stage, there are no provisions on any sanctions in case of non-compliance, but it is likely that companies which do not comply will have disadvantages in the running of business, or suffer sanctions.

It is anticipated that under the Climate Change and Energy Transitions Act, climate risks will no longer be considered unspecified and abstract, but rather definite and directly linked to a company's business model, with extensive financial and reputational implications.

Consequently, new regulations under the Act will have a wide scope of impacts on risk exposures for corporates, their directors/officers and their financial lines insurers.

Sweden

In December 2020, the Swedish Financial Supervisory Authority (SFSA) published preparatory guidelines for financial companies affected by the EU Disclosure and Taxonomy Regulations. Financial companies have to identify sustainability factors and how sustainability risks are handled in the company's business.

Failing to do so may result in penalties and a potential breach of a director's fiduciary duties, thus triggering claims against the corporate as well as its directors/ officers.

A breach of the preparatory guidelines does not result in sanctions from the SFSA, instead its purpose is to provide recommendations to companies affected by the disclosure and taxonomy regulations regarding how to avoid non-compliance. The SFSA further advises the affected companies to be aware of new national laws, regulations, and recommendations regarding both EU regulations.

During 2020, the SFSA investigated to what extent insurance companies' portfolios and financial assets were aligned with climate scenarios, including to what extent they were exposed to transition risks. This investigation was conducted as part of a pilot study by using the Paris Agreement Capital Transition Assessment (PACTA) tool to assess the insurance companies' assets' compatibility with the climate goals in the Paris Agreement.

The preliminary findings in this study, presented in the SFSA's Sustainability report 2021 – the climate in focus indicated that Swedish insurance companies' placements are not in line with the Paris Agreement.

However, the PACTA tool indicates that the total exposure to climate relevant sectors is low and that the companies' direct exposure to transition risks is limited. In Sweden, regulation regarding advice on insurance-based investment products in the SIDA states that provisions in the Disclosure Regulation are applicable also to insurance intermediaries with less than three employees despite the exemption in article 17 in the Disclosure Regulation.

Furthermore, the Swedish Insurance Business Act 2010 and the Swedish Insurance Distribution Act 2018 (SIDA) both state that the SFSA shall intervene if an insurer has breached any of its obligations under SFDR and/or Taxonomy Regulations.

Australia

Australia is yet to mandate specific disclosure of climate-related financial risk but the expectations of Australia's financial regulators and corporate entities continue to increase.

> **However, the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA), the Australian Securities Exchange (ASX) and the Reserve Bank of Australia (RBA) have all published guidelines and recommendations concerning assessing and disclosing climate-related financial risk.**

ASIC and the ASX have also recognised that climate-related risk is, in any event, a subset of a company's financial risk.

Further and with respect to disclosure, ASIC has already:

- Encouraged directors of listed companies to disclose useful information to investors and recommends that listed companies with material exposure consider reporting under the TCFD framework.
- Been monitoring the adoption of TCFD reporting and the development of climate-risk disclosure practices.

Against this backdrop, Australia has already witnessed an increase in climate-related litigation with corporates (in addition to governments) squarely in the firing line.

Until it is specifically mandated for Australian companies to make disclosures in line with the TCFD, directors of Australian companies should:

- Consider their obligations under the Corporations Act 2001 (Cth) (Corporations Act) with respect to operating and financial review (OFR) disclosures in annual reports and other documents. Directors should note that an OFR must include a discussion of climate risk when it is a material risk which could affect the company's financial performance.
- Be cognisant of a potential breach of their obligation to exercise their powers and discharge their duty of care and diligence under section 180(1) of the Corporations Act if they fail to adequately assess and disclose climate-related financial risk.
- Remember the increasing regulatory focus on 'greenwashing' (where the disclosures overrepresent the extent to which a corporation's practices are environmentally friendly, sustainable or ethical) by the Sustainable Finance Taskforce established by the International Organisation of Securities Commissions.
- Be aware of the statutory prohibition against misleading or deceptive conduct and the giving of false or misleading statements relating to financial products. A company's ESG-related products must accurately reflect the company's practices.
- Be proactive to avoid potential investor class actions which may seek better climate action from companies.

Lastly, the Investor Agenda Australia Country Policy Group recently released a roadmap calling for Australia to adopt mandatory financial disclosure for climate change risks by 2024.

The Group recommends further efforts, signals and changes to ensure:

- Disclosures keep pace with best practice and obligations among Australia's major trading partners.
- Reporting is brought in line with industry expectations and user needs.
- Standardisation across jurisdictions is considered.

In light of the increasing call for mandatory disclosure of climate risks, Australian companies and their directors and officers (and their insurers) must take heed of these developments and assess and disclose their climate-related financial risk accordingly.

Hong Kong

The Hong Kong Monetary Authority and the Securities and Futures Commission (SFC), established the Green and Sustainable Finance Cross-Agency Steering Group (the Steering Group) in May 2020. Prompted by COP26, the Steering Group aims at developing Hong Kong into a regional carbon trading centre.

> **One of the many objectives that the Steering Group aims to accomplish includes pushing local ESG disclosure standards to align with the TCFD framework by 2025.**

Whilst the Steering Group is progressing the advancement of local ESG disclosure standards, the following ESG disclosure requirements are already in place.

Schedule 5 of the Companies Ordinance (Cap. 622) (CO) stipulates that the director's report for each financial year shall contain a business review with discussion on the company's environmental policies and performance. This requirement applies to all registered companies in Hong Kong (i.e. both listed and unlisted) unless a reporting exemption applies.

The ESG Reporting Guide issued by the Hong Kong Stock Exchange (HKEx) requires listed companies to publish ESG reports annually to report on oversight of ESG issues, ESG management approach and strategy, and review progress. It also provides a 'comply or explain' framework for areas such as greenhouse gas emissions and waste production, energy consumption, environmental impact and mitigation of climate-related issues.

Since 1 January 2022, the SFC has mandated that funds incorporating ESG factors as their investment focus to:

- Name the funds to reflect their ESG focus.
- Disclose in their offering documents the ESG focus, investment strategy, allocation, reference benchmark and risks, and any additional information such as measurement and monitoring of the ESG focus.
- Assess attainment of the ESG focus at least annually, and disclose the results to investors.

Fund managers handling collective investment schemes are also required by the SFC to take climate-related risks into consideration in their investment and risk management processes, and make appropriate disclosures. In particular, large fund managers (with at least HK$8 billion in assets) must comply with the enhanced standard for disclosure of greenhouse gas emissions starting from November 2022.

In Hong Kong, failure to comply with the requirements for the directors' report in accordance with the CO may result in criminal sanctions against directors; failure to disclose ESG information and climate-related risks, pursuant to the rules imposed by the SFC and the HKEx, may result in disciplinary sanctions and attract civil and/or criminal liabilities for corporates and their directors.

India

Since 2012, India's market regulations have made it mandatory for ESG initiatives to be included within annual reports of the top 100 listed companies.

To keep pace with the changes in global environment, emerging global trends on ESG considerations and increased awareness of investors, in May 2021, the Securities and Exchange Board of India (SEBI) implemented new sustainability related reporting requirements for the top 1,000 listed companies by market capitalisation.

> **The new format is called a Business Responsibility and Sustainability Report (BRSR), and is a significant step towards bringing sustainability reporting on par with financial reporting.**

Key environment-related disclosures include an overview of ESG opportunities and risks, resources usage, air pollutant and green-house emissions, and waste generated and waste management practices. BRSR reporting is voluntary for FY 2021-22 and mandatory from FY 2022-23.

The situation in India is therefore similar to the UK, and it remains to be seen how compliant companies are with their disclosure obligations, and whether claims can be expected against companies and/or their directors/officers in case of non-compliance.

United States

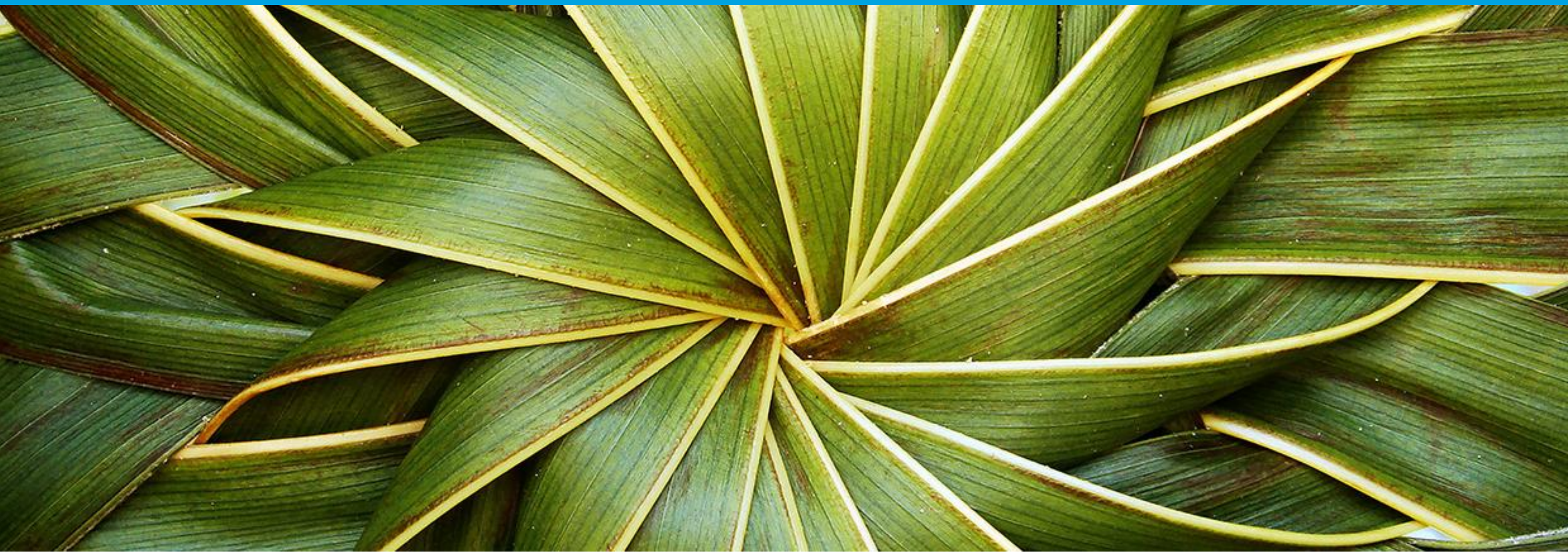
On February 8, 2010, the SEC first issued guidance identifying specific climate change-related issues that might trigger public company disclosure requirements under the SEC's existing rules and regulations. Under the 2010 Guidance, public companies are instructed to regularly assess and report:

- Whether any enacted climate change legislation or regulation is reasonably likely to have a material effect of the registrant's financial condition or results of operation.
- The impact on their business of treaties or international accords relating to climate change.
- Legal, technological, political and scientific developments regarding climate change [that] may create new opportunities or risks for registrants.
- Significant physical effects of climate change, such as the effects on the severity of weather, sea levels, the arability of farmland, and water available and quantity, that have the potential to affect a registrant's operations and results.

However, in recent years, ESG - and all of its legal and regulatory risks - have come to the forefront of corporate boards, regulators and financial lines insurers. In March 2021, the SEC updated its examination priorities to include a greater focus on 'climate and ESG-related risks'.

> “This year, the Division is enhancing its focus on climate and ESG-related risks by examining proxy voting policies and practices to ensure voting aligns with investors' best interests and expectations, as well as firms' business continuity plans in light of intensifying physical risks associated with climate change.
>
> Through these and other efforts, we are integrating climate and ESG considerations into the agency's broader regulatory framework.”
>
> ***Acting Chair Allison Herren Lee*, *SEC***

Then, in November 2021, at COP26, the United States announced a 'whole-of-government' approach to climate change, including its commitment to supporting regulatory reforms to "accelerate the development and deployment of zero- or low-emissions technologies". Separately, activist investors and others may seek to use litigation against US corporations to advance their



ESG agendas, which may include board diversity and sustainability concerns.

Significantly, on 21 March 2022, the SEC announced its proposed rule on the 'Enhancement and Standardization of Climate-Related Disclosures for Investors', which is intended to require "consistent, comparable, and decision-useful information" on climate-related disclosures. Comment is required by 30 May 2022 or 30 days publication of the rule to the Federal Register – whichever is later.

Under the current legal environment, a board's failure to adequately take into account climate and ESG related issues will mean that directors and officers may be liable to the company's shareholders under the federal securities laws for inadequate disclosure. Further, directors and officers may be liable to the company itself for breaches of fiduciary duties owed to the company.

These lawsuits may be brought either under a theory of breach of the duty of loyalty, or breach of the duty of care. With respect to the duty of loyalty, in *Marchand v. Barnhill*, the Delaware Supreme Court held that boards must have systems in place allowing them to monitor critical operations and cannot disregard 'red flags' that arise. This is therefore an issue that should be a priority for all corporates and their boards.

Latin America and the Caribbean (LAC)

In 2014, the Brazilian Monetary Council (Conselho Monetário Nacional – CMN) approved guidelines for the establishment and implementation of ESG policies of financial institutions and other entities authorised to operate by the Central Bank of Brazil.

According to Resolution 4327 an institution must:

- Designate a director responsible for compliance with ESG policies.
- Formalise ESG policies and ensure its internal and external disclosure.
- Maintain relevant documentation at the disposal of the Central Bank.

> **Furthermore, on 15 September 2021, the Brazilian Central Bank released six new rules regulating ESG risks in the National Financial System, which will come into force sometime this year.**

These rules relate to:

- The analysis and risk management of financial institutions.
- Sustainable impediments to contracting rural credit.
- The mandatory disclosure of an ESG risks and opportunities report.

However, on the whole, ESG regulation in the LAC is still to be developed and there is no unified strategy among the LAC countries as to how the COP26 commitments will be put into practice.

For example, Colombia proposed to reduce carbon emission by 51% by 2030 and to be carbon neutral by 2050, whilst Mexico and Brazil did not commit to any further reduction in emissions, although being the largest producers of carbon in that region.

The other difficulty is that commitments made by governments at COP26 are not directly enforceable and most countries in LAC have not yet addressed or explicitly included climate-related risks in binding regulations and/or supervisory measures.

However, as with any other jurisdiction, it is likely that with new regulations, there will be new exposures for companies and their board and in particular in regions with the most active regulators – Colombia and Brazil.

Comment

“Increased regulatory focus on ESG, coupled with demands for transparency from increasingly active shareholders, means that companies and their directors and officers face real challenges in 2022.

D&Os must understand shifting regulatory and societal expectations and ensure the company responds. The spotlight will be firmly on any non-compliance, resulting in both legal and reputational vulnerability for companies and D&Os - and increased risk for their insurers.”

Jenny Boldon, Partner, London

The increased examination of ESG commitments – including climate related disclosures - will be a priority for directors/officers globally as they wait to see how moving from voluntary to mandatory disclosure requirements plays out. It is likely that challenges will arise as corporates are required to navigate a landscape of developing laws and standards. Notwithstanding the shifting regulatory environment, insurers – like most companies – know that it is only a matter of time before regulators or the general public discover any discrepancies in ESG promises, putting reputations at risk.

What this report shows us is that globally, corporates and their boards need to prioritise and carefully consider climate change, net zero commitments and climate related risks. ESG must be a formal agenda item, not an ‘AOB’. How businesses manage climate change risks, communicate environmental credentials and significantly, whether they are (or are not) ‘practising what they preach’ will be subject to examination on all fronts.

The shift to mandatory requirements begins in the UK this week with the introduction of mandatory climate disclosures, and the response to and any fall out as a result of these increased demands will be monitored with interest by directors/officers globally.

Failure to comply with disclosure obligations, whether outright or through misstatements overstating a company’s commitment to climate related risks, will leave corporates and their directors/officers exposed to future claims and reputational damage. Future risks include miss-selling type claims, allegations of ‘greenwashing’ and ultimately enforcement actions or breach of fiduciary claims for the directors/officers. Reputational risk on the back of such claims is likely to have severe and widespread consequences.

Examples of the litigation risks presented have already been seen. In January 2022, Dutch activist group Milieudefensie - buoyed by their successful claim against Shell - wrote to 30 corporations (including insurers Aegon and NNGroup) suggesting that these corporations must reduce emissions to avoid litigation and have implied that they will consider commencing proceedings against them if they fail to do so. More recently, Client Earth has issued a Letter of Claim against the directors of Shell, alleging that the board has failed to adopt and implement a climate strategy that truly aligns with the Paris Agreement. As regulations develop, this trend will inevitably increase in its scope and frequency.

Most would agree that global commitment to climate change should be a priority. What follows is that climate related risk is a real one for businesses, and all signs suggest it is one that is here to stay long term - for corporates, directors and their financial line insurers.

Get in touch

If you would like to discuss any of the issues raised in this report in more detail, please reach out to your Kennedys client relationship partner or get in touch with any of the contacts listed below.

To find out more about our services, expertise and key contacts, go to: kennedyslaw.com/climate-change

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