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Responsible Investment News and Views

In this quarter's News and Views, we look at the first wave of schemes' reports under the Taskforce for Climate-related Financial Disclosures ('TCFD'). We've looked at the learnings from TCFD so far, identified trends across published reports and tried to find any common areas of challenge for schemes. In this quarter's votes, we've focused on resolutions impacting the banking sector and its financing of fossil fuels. In our stewardship section, we look at the recent FCA consultation on labelling of funds.

TCFD – The First Wave

The TCFD governance and reporting framework and regulations sought to help schemes better understand and embed into scheme practice the consideration of climate-related risks and opportunities. The expectation was that there would be an improved understanding and management of those risks and greater consideration of emerging opportunities. The key challenges noted by schemes required under regulation to report from 1 October 2022 typically revolved around data availability, time and resource constraints, as well as finding efficient ways to undertake TCFD-related work when considering TCFD versus other priorities and workstreams.

Lessons learned from the first wave:

1. Meeting the governance requirements was found to be somewhat easier, despite being the first to be caught by the legislation. This is in part due to larger schemes having established governance processes and practices already, existing sub-committee structures already being in place to cope with the work and potentially higher budgets. So ensuring good governance was already in place was a key preparatory action.

2. The strategy pillar required greater effort, not least undertaking climate scenario analysis. However, while scenario analysis generally provided a good starting point for discussion, DB schemes typically found it difficult to include longevity risk and covenant risk to the degree that may have been preferred, thereby limiting the ability to gain a complete picture of potential outcomes. DC schemes used a member-outcomes-based approach to assess scenario analysis, which worked well at the macro level but led to the inevitable "So what?" question at the strategy level. So while scenario analysis produced good discussions, it was of limited use in influencing decision-making. We expect that this will evolve over time.

3 Schemes with good existing risk management processes found embedding climate risks within those existing processes to be a relatively simple process, with significant use of RAG assessments of climate-related risks as an effective tool for doing this. However, we would hope to see more focus on stewardship as a risk management tool in future.

4 Under the metrics and targets pillar, the biggest challenge has been the availability of reliable data, particularly for private market assets. Many schemes selected data quality as their additional metric, with the goal of engaging with managers and using their influence in order to help drive improvements over time. Those schemes that engaged early with managers and then regularly throughout the TCFD process were better informed of the challenges faced within specific mandates. This also resulted in enough time ahead of the TCFD report being drafted for full discussions about appropriate targets for the scheme to take place and clearer steps towards achieving those targets.

First-wave schemes should now:

1 Review governance and risk management processes on an annual basis to ensure they remain appropriate and accurately reflect the actions being taken and processes in place.

2 Consider whether scenario analysis needs to be rerun during the second year of reporting and be clear on the reasons why not, if that is the decision made. Scenario analysis should be undertaken at least every three years, as well as in those intervening years when appropriate – eg if there are large changes to investment strategy or changes to key assumptions used since the previous analysis.

3 Review metrics to ensure that the chosen metrics remain appropriate and, should a metric be deemed inappropriate, select a replacement metric to report on. Start including scope 3 within emissions metric reporting and pressing for better data.

4 Both review the chosen target(s) to ensure it remains appropriate and then measure performance against chosen targets. The second TCFD report should include a description of the steps that the Trustee is taking to achieve the targets set, with an explanation of the reason if a target is missed or replaced.

Finally, the key steps that second-wave schemes (ie those starting to produce a TCFD report this year) will be taking are:

1 **Undertaking further training** to ensure that all parties involved increase the appropriate level of knowledge and understanding. Some decisions need to be taken quickly and having solid knowledge of both the requirements and the issues is essential.

2 **Evolving good governance**, not only enabling climate-related issues to be embedded effectively across current practices, but also in order to manage potential resource and time constraints by ensuring an efficient approach with clear roles, responsibilities and delegation.

3 Identifying the key activities and decisions required, but also **adopting a proportionate approach to decision-making**. For example, scenario analysis and calculating metrics are generally more time-consuming activities. Recognising how these can fit into broader strategic activities, decisions and priorities and what approach to take can simplify processes.

Climate-related shareholder resolutions in the banking sector

Financing emissions

In May 2021, the International Energy Agency ('IEA'), completed a comprehensive study investigating how to transition to a net zero energy system by 2050 while ensuring stable and affordable energy supplies, providing universal energy access and enabling robust economic growth. The IEA's conclusion was that to achieve net zero emissions, there can be no new development of oil and gas fields or coal mines beyond those already approved.

Despite this, a 2022 fossil fuel finance report, Banking on Climate Chaos, by Sierra Club found that fossil fuel financing from the world's 60 largest banks has reached US$6.4trillion in the six years since adoption of the Paris Agreement. In particular, the report found that US banks are the single worst grouping of fossil fuel banks, with the top four fossil fuel funders in the world (JP Morgan Chase, Citi, Wells Fargo and Bank of America) all headquartered in the US, joined by Morgan Stanley and Goldman Sachs in the top 14. Together, these six banks provided 29% of fossil fuel financing identified in 2021 and 31% of fossil fuel financing since the Paris Agreement.

A ShareAction Report, In Debt to the Planet, focused on Europe's top 25 banks and their approaches to tackling climate change and, similarly, found that banks are falling short on climate and biodiversity action. A key finding of the report was that banks' fossil fuel policies are not strong enough to align their financing with 1.5C pathways.

All of the named US banks are members of the Net Zero Banking Alliance ('NZBA'), an industry-led, UN-convened alliance under the umbrella of the Glasgow Financial Alliance for Net Zero ('GFANZ'). NZBA brings together a global group of banks committed to aligning their lending and investment portfolios with net zero emissions by 2050. Signatory banks need to set intermediate targets for 2030 or sooner using science-based guidelines.

While NZBA members have committed to set emission reduction targets for their energy portfolios, the alliance's guidelines neglect members' approaches to fossil fuel expansion. The ShareAction Report found that NZBA members in scope of their analysis have provided at least US$38 billion in financing to the top 50 upstream oil and gas expanders since the launch of the alliance.

The findings of the Sierra Club and ShareAction reports underscore the fact that, despite being members of NZBA, banks need to implement policies that end their financing for fossil fuel expansion, or they are unlikely to meet climate commitments.

Financing fossil fuel presents material risks for banks, which could negatively influence performance and which shareholders should be cognisant of. On one hand, if the consumption of fossil fuels does not decrease to the extent needed to limit global warming to 1.5C, the economy will suffer from severe physical impacts of climate change, potentially leading to litigation against those providing finance. On the other hand, if demand decreases in line with 1.5C scenarios, there is the potential for the initially promised return not to be delivered and assets to become stranded. For example, ShareAction reported US$145 billion in write-downs of fossil fuel assets in 2020.

Shareholder resolutions in 2022

One action shareholders can take in escalating issues of pertinence is filing resolutions at companies' upcoming annual general meetings ('AGM'). A slate of resolutions calling for policies to phase out financing for fossil fuel expansion and adopt fossil fuel lending while underwriting policies consistent with the IEA's net zero 2050 scenario were filed in the 2022 proxy voting season. As the table below illustrates, these resolutions received between 8 and 15% support, a significant milestone for these first-of-a-kind proposals.

2022 resolution outcome	For %	Against %
JP Morgan Chase	15.6	84.4
Bank of America	11.0	89.0
Citigroup	13.0	87.0
Wells Fargo	11.4	88.6
Goldman Sachs	11.3	88.7
Morgan Stanley	8.5	91.5

Source: Insightia

Rationales provided by asset managers who voted against these types of resolutions at banks include BlackRock's, which stated that it wouldn't support climate resolutions that were 'unduly prescriptive and constraining'. These sentiments were shared by LGIM, which provided rationale for voting against the climate-related resolution at JP Morgan Chase in May 2022 that: "the wording of the resolution is loosely drafted in such a way as to be overly prescriptive in the Board's actions".

Looking to the 2023 proxy voting season

The banking sector continues to play a critical role in achieving global net zero by 2050 goals. Shareholder advocacy group As You Sow acknowledged that banks have made significant progress over the last five years. However, they also note that these banks need to set policies and be more transparent about how they are reaching their climate goals.

As You Sow are one of several institutions and advocacy groups that have announced the filing of climate-related shareholder resolutions at major US fossil fuel financing banks. The table below illustrates the various calls being made on banks:

Resolution	Target companies
Adopt policies to **phase out financing** of new fossil fuel exploration and development	Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, Wells Fargo
Disclose **robust transition plans** on how they intend to align financing activities (lending and underwriting services) for other industries to ensure they meet goals to cut greenhouse gas emissions by 2030	Bank of America (BofA), Goldman Sachs, JP Morgan Chase, Morgan Stanley, Wells Fargo
Set 2030 **absolute emissions reduction targets** for energy sector financing	JP Morgan Chase, BofA, Goldman Sachs, Royal Bank of Canada

A coalition of institutional investors have filed climate-related shareholder resolutions to force "more climate-friendly policies that better align with the firms' public commitments to combating the climate emergency". The resolutions request that the respective Board of Directors adopt a policy for a time-bound phase-out of lending and underwriting to projects and companies engaging in new fossil fuel exploration and development. While each of these banks have committed to align their financing with the goals of the Paris Agreement, they continue to finance and facilitate fossil fuel expansion. This not only exposes them to accusations of greenwashing but leaves them further exposed to material climate-related risks.

Further, As You Sow filed resolutions at multiple US banks requesting that they report their transition plans and describe how they intend to align financing activities with their 2030 sectoral greenhouse gas emissions reduction targets. The resolution, like others, cited the findings of the Sierra Club report, Banking on Climate Chaos, which found that US banks continue to be the single worst grouping of fossil fuel funders. Each of the banks is a member of the NZBA and, while they have committed to aligning lending and investment portfolios with net zero by 2050, the resolutions note that these targets alone are insufficient. The resolution seeks disclosure demonstrating the banks' concrete transition strategies to credibly achieve their disclosed emission reduction targets.

Finally, the New York City Comptroller filed resolutions with multiple banks calling them to set stricter 2030 greenhouse gas emissions reduction targets for portfolio companies. The shareholder proposals request an absolute reduction target aligned with a science-based net zero emissions pathway, widely recognised as the standard for evaluating whether companies are genuine in their net zero pursuits. New York City Comptroller Brad Lander commented that "shareholders applauded these banks when they set net-zero goals – but it can't be all talk. We expect them to take the steps needed now to reduce emissions on the timeline to which they have committed. Absent a concrete plan to reduce absolute emissions in the real world in the near term, any net zero plan rings hollow."

What should asset owners do?

Exercising voting rights is an important element of active ownership. With many now focused on the management of climate-related risks, scrutinising the actions of asset managers in how they engage with banks on these issues is critical.

While the subject of climate change is both complex and nuanced, asset owners could use this climate theme, that of financing carbon emissions, as a basis for more detailed engagement with their managers.

Ask your managers for their views on this topic, what dialogue they have had with banks on these issues, how they intend to vote on these resolutions and to provide a rationale for these voting decisions. Where asset managers vote against resolutions, ask what the catalyst would be for managers to change their view.

ESG Snippets

SFDR 8 and 9 Fund disclosure changes

The European Union's Sustainable Finance Disclosure Regulation (SFDR) Regulatory Technical Standards (RTS) have applied since on 1 January 2023. The RTS requires investors to disclose the most significant negative impacts of investment decisions on sustainability factors relating to environmental and social issues, known as principal adverse impacts (PAI).

This comes as managers re-evaluate SFDR disclosure requirements, with fewer seeking to meet Article 9 requirements in favour of Article 8. Notable changes include all but one of BlackRock's ETFs, a total of 16 funds with US$26 billion in managed assets, that will now disclose against Article 8 instead. Amundi has taken similar steps across nearly all funds previously set to disclose against SFDR Article 9, which between them managed €45 billion. *Clients are advised to check with advisers on funds they are invested in, whether they seek to disclose against SFDR Articles 8 or 9 and, more importantly, if this has been downgraded recently.*

FCA consultation on ESG labelling

The Financial Conduct Authority (FCA) has recently consulted on the introduction of sustainable disclosures and labelling regime in an attempt to tackle greenwashing and build consumer trust. The FCA is concerned with firms making misleading and exaggerated sustainability-related claims across the sustainable investment universe. The FCA has proposed an 'anti-greenwashing' rule, which would be applicable to all regulated firms with the intention of emphasising the notion that sustainability-related claims must be clear, fair and not misleading.

The FCA's proposals set out three different 'sustainable' labels for investment products, namely: 'Sustainable Focus' whereby at least 70% in assets must meet a credible sustainability standard; 'Sustainable Improvers' whereby stewardship is key to deliver improvements to become more sustainable; and 'Sustainable Impact', whereby assets must deliver a specific positive impact. The proposed regime will also define the criteria that products under each label must adhere to, while also limiting the use of certain sustainability-related terminology.

Tackling Greenwashing

From both an industry and regulatory perspective, greater focus has been placed on tackling greenwashing to reduce the number of offenders and restricting the ease with which greenwashing offences can be committed.

At an industry level, a group of prevalent ESG sector names have called on EU authorities, in response to an ongoing EU consultation, to provide harsher penalties for greenwashing offenders in accordance with the scale of the offence. The group has recommended that the EU explore a wider range of penalties including incentivising media groups and researchers to monitor greenwashing allegations.

The European Securities and Markets Authority (ESMA) has called for evidence on potential greenwashing practices across the whole EU financial sector. The format for the Call for Evidence is a survey, and all interested parties are welcome to contribute, including financial institutions as well as other stakeholders such as retail investors, consumer associations, NGOs and academia.

Hymans Robertson's view

It was inevitable that the growing focus on ESG issues and sustainable investment would result in greater scrutiny of the claims being made and demands for accountability. After all, if a manager is making claims that their investment strategy is sustainable, it is reasonable for any investor to both be able to understand how this is defined and to know whether those products are making an assessable real-world impact.

We have long highlighted the challenges of ranging terminology within the industry, particularly that different words are often used to mean similar things, and the need to look beneath the bonnet of sustainable funds to better understand products. We therefore welcome the FCA's labelling proposals and their approach to preventing the misuse of terms such as 'ESG', 'green' and 'sustainable'.

It is appropriate to recognise that standards evolve and within this comes the need to regularly re-evaluate how managers are being tested. We updated our own assessment framework over the course of 2022 to ensure that we have set expectations appropriately. These evaluations will be reflected in our manager ratings.

To understand how we assess managers and products, please speak to your Hymans consultant.