



SHCOG

**Compliance's Role in
Managing ESG Risks**



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Client demand for Sustainable Finance is increasing, Bank's control frameworks need to scale with Business activity

Projections suggest that the ESG share of overall AuM will be 21.5% of all assets by 2026¹

Most large Banks have targets to provide \$1tn Sustainable Financing by 2030²

Banks need to meet their own Net Zero Targets, which include a reduction in financing across specific sectors

Opportunity

New revenue streams and available wallet share for ESG-labelled products

Risk

New products and deal structures raise Conduct and Regulatory Risks; primarily Greenwashing Risk

Opportunity

Existing and new clients will require financing to transition a Net Zero state

Risk

Poorly defined roadmap to meet targets may mis-align incentives and lead to mis-selling

Opportunity

Meet Net Zero targets and drive positive environmental impacts

Risk

Unclear transition pathways to reduction in financing impacted Sectors may lead to missed targets

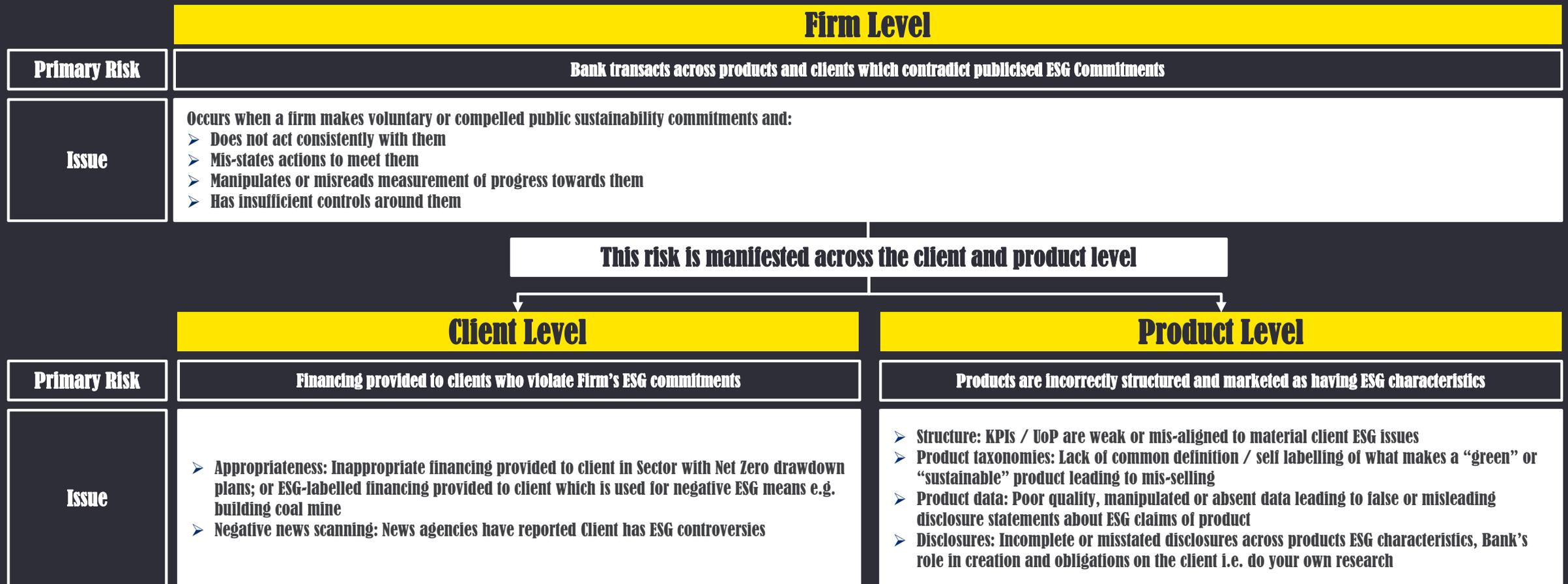
MANAGE GREENWASHING RISKS WHILE SUPPORTING THE BUSINESS

1 - [Exponential Expectations for ESG \(harvard.edu\)](https://www.harvard.edu)

2 - [Financing the Transition: Energy Supply Investment and Bank Financing Activity | BloombergNEF \(bnf.com\)](https://www.bloombergnef.com)

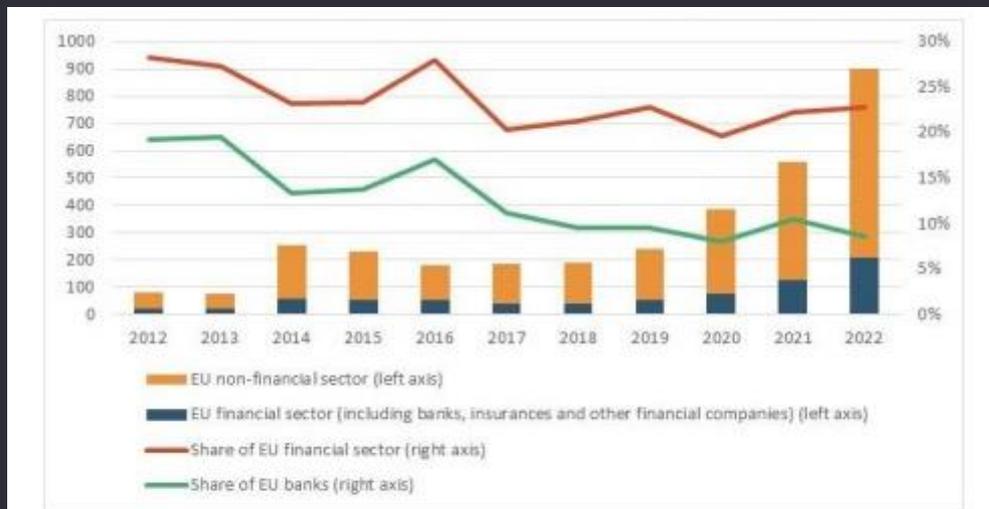
Greenwashing risks can arise through inconsistencies between the Firm's Net Zero strategy and the products and clients it transacts across

FCAs anti greenwashing rule states '*regulated firms to ensure that the naming and marketing of financial products and services in the UK is clear, fair and not misleading, and consistent with the sustainability profile of the product or service i.e. proportionate and not exaggerated*'.



There are an increased number alleged greenwashing incidents, leading to an increased number of speeches and publications from Global Regulators on Greenwashing

Number of alleged Greenwashing incidents in the EU Financial and Banking Sector



Source: RepRisk ESG Data Science, www.reprisk.com

Example of increased Regulatory activity

- *FCA Probes on Sustainability Linked Loans*
- *ESMA and EBA Interim Report on Greenwashing*
- *Dear CEO ESG Benchmarks Review*
- *SEC launched Climate and ESG Task Force initiatives to proactively identify ESG-related misconduct*
- *HKMA Guidance on Greenwashing*

How should firms consider tackling greenwashing risk and disclosure obligations, taking account of existing principles and proposed greenwashing rules?

ESMA and EBA Progress Report on Greenwashing provides an initial definition of Greenwashing...

“Practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants”

... And provides a view of the role of Compliance in mitigation of Greenwashing

“The Compliance function has an important role in ensuring compliance with climate-related laws, rules, regulations and standards, and in advising business relationship officers on the compliance risks of greenwashing, including with regard to products and transactions labelled as green, ESG or sustainable.”

Compliance functions in some institutions find an increasing need to mitigate the risk of greenwashing, against the backdrop of regulatory developments and commitments voluntarily made. This may lead in some institutions to follow-up actions which relate, for example, to staff knowledge and expertise, data and methodologies, and governance and internal control frameworks”

Compliance should support the establishment of Governance and standards to support the Business in new activity...

Component	Themes	High Level Considerations
Ensuring compliance with climate-related laws, rules, regulations and standards	<ul style="list-style-type: none"> ➤ Regulation ➤ Advice ➤ Market Standards ➤ Horizon Scanning 	<ul style="list-style-type: none"> ➤ Provide the Business with a global framework of standards to ensure compliance with rules, regulations and standards, with certain Regional carve outs where appropriate ➤ Provide advice to the Business on acceptable market standards (e.g. ICMA, SASB KPIs, etc.), and where required advise on further steps to be taken over and above market standards to cover off any residual risk ➤ Proactive horizon scanning to identify any new requirements that may impact the Bank, lobbying where required, and then educating and setting a framework for the Business to comply
Advising business relationship officers on risks of greenwashing, including with regard to products and transactions labelled as green, ESG or sustainable	<ul style="list-style-type: none"> ➤ Product Governance ➤ Transaction Review ➤ Governance ➤ Advice ➤ Disclosures 	<ul style="list-style-type: none"> ➤ Creation of Sustainable Finance definition and product or transaction characteristics that are required to obtain ESG-labelling ➤ Support the creation of a Global Governance structure to identify, monitor and mitigate Greenwashing risks (e.g. enhanced ESG-labelled Product and Transaction Due Diligence forums) ➤ Proactive member of ESG Governance forums across a spectrum of activities (i.e. challenge and advise the Business on the structure and ambition of ESG-labelled transactions) ➤ Advising and providing the Business with a disclosure framework for marketing materials to support the transparent disclosure of sustainability objectives and features for clients

... and enhance supporting capabilities to best identify and mitigate Greenwashing Risks

Component	Themes	High Level Considerations
Staff knowledge and expertise	<ul style="list-style-type: none">➤ Training➤ Competence	<ul style="list-style-type: none">➤ Set minimum knowledge standards / qualifications for staff to provide ESG related products or transactions➤ Educate staff on how Greenwashing can arise and the control framework the Bank has to mitigate➤ Educate staff on regulatory or market standards and how they apply to the Business they conduct
Data and methodologies	<ul style="list-style-type: none">➤ MI➤ Surveillance➤ Monitoring	<ul style="list-style-type: none">➤ Collation and presentation of ESG specific metrics (e.g. escalated ESG transactions, complaints, thematic outcomes testing, etc.) to identify emerging themes and trends towards Greenwashing Risks➤ Creation or enhancement of framework on the use of externally provided ESG Ratings➤ Enhanced Surveillance and Monitoring (e.g. updated lexicons to incorporate Greenwashing, sentiment analysis, etc.) to identify ESG-related risks, including outcomes testing to ensure the right client outcomes are delivered

How do Compliance grapple with the fundamental risks and regulations that arise with ESG and what are the challenges?

Compliance's Operating Model should be enhanced to manage ESG Risk's which can be aligned to TCFD's 4 key pillars

ESG raises a number of Risks which require identification and management. These are often embedded within existing taxonomies as Risks can be portrayed as different shades of existing Risks e.g. Greenwashing as a form of mis-selling

Core Elements of Recommended Climate-Related Financial Disclosures



Operating Model Pillars: Governance and Strategy

Governance

Maintaining a strong corporate governance structure in the face of an evolving and complex sustainability landscape is a critical success factor.

Key Market Themes



Challenges and Pain Points

- Resourcing and technical insights
- Clarity on routes to and from sustainability committees – business and functional governance process to board-level committees – and how to embed in BAU
- Roles and responsibilities towards identification and management of key risks across 1LoD, 2LoD and Group

Strategy

Sustainability strategy has been developed aligned to an organisations purpose, and should be anchored in key thematic areas.

Key Market Themes



Challenges and Pain Points

- Accountability and responsibility across business lines and functions
- Aggregation of implementation strategy with clear set of tangible initiatives, defined ownership, KPIs and delivery roadmap
- Frameworks to manage emerging topics (e.g. nature, social inequality, etc.)
- Cascading of organisational sustainability strategies to product strategies

Operating Model Pillars: Risk Management and Metrics and Targets

Risk Management

Regulatory landscape is evolving, with a number of complex global regulations. Banks must expand their sustainability risk management frameworks, to encompass a wider compliance and reputational lens.

Key Market Themes

Proactive horizon scanning, understanding regional differences

Established committees to manage and mitigate sustainability risk

Focus on risk identification, monitoring and policies, including Surveillance

Risk and Compliance embedded in governance

Sustainability integrated into business, risk and investment decisions

Enhancement of Risk Taxonomy to consider ESG Risks

Challenges and Pain Points

- Clear articulation of responsibility for compliance monitoring
- Compliance frameworks should include identification of ESG risks, policies and how those policies are embedded
- Technical knowledge to perform horizon scanning and reg interpretation
- Complex sustainability risks and regulations spanning multiple parts of the bank

Metrics and Targets

Mature banks are shifting focus from target setting to credibly demonstrating progress at pace. Monitoring metrics and targets will be key, alongside investment and build in supporting infrastructure.

Key Market Themes

Embed targets and strategies into BAU

Targets and metrics embedded into scorecards

ESG-labelled KPIs should be clearly linked to targets

Enhancement of Conduct Risk metrics to consider Greenwashing risks

Metrics to enable real time assessment of progress vs ambitions and drive Business decision making

Ongoing client review to ascertain alignment with Firm ESG commitments

Challenges and Pain Points

- Lack of mechanisms to look at sector challenges and transitions across groups and different lines of business
- Infrastructure not aligned with delivery of sustainability ambitions: data gaps, technology build, skills and capability

Options for integrating ESG into operational risk frameworks – embed as a principal risk within existing taxonomies, treat as cross-cutting, or create a new ESG taxonomy?

The cross-cutting risk option

CLIMATE FINANCIAL RISK FORUM GUIDE 2020

RISK MANAGEMENT CHAPTER

June 2020



- **Decision based on initial materiality assessment of different ESG risk types**
- **May take one mapping approach for environmental and social risk, and another for climate risk**
- **CFRF sees a cross-cutting approach to climate risk as good practice**
- **Treated as manifesting through established principal risk types**
- **Requires material risk owners to understand and identify physical and transition risk drivers**
- **High level of collaboration needed with internal and external experts to fill knowledge gaps**
- **UK PRA expects documented embedment in risk framework, committee structures and three lines governance**
- **EBA has noted banks using a cross-cutting materiality approach are “limited in terms of depth and sophistication”**

The option of a new internal ESG risk taxonomy

- **A reaction to divergent range of sustainability standards, disclosure expectations and evolving regulatory ESG definitions**
- **Choice between covering climate risk, environmental and social risk, good governance, or focus on sustainability risk**
- **Inclusion of financial vs non-financial risk**
- **Risk ownership is less obvious – impact on risk culture**
- **CFRF advises developing taxonomy at the client, transaction and portfolio level to assess risk concentrations**



What are some of the key ESG risks within trading businesses and how are firms managing reputational risk around net zero commitments?

Key questions Compliance should be asking themselves

Have we updated our Risk Taxonomy to consider all Greenwashing?

Are we aware of all ESG Regulations that are impacting or will impact the Bank, and are we adequately prepared?

Is our Risk Management Framework fit for purpose to identify, monitor and mitigate Greenwashing?

Have we updated our Surveillance and Monitoring approach to consider Greenwashing scenarios?

Are we well represented across all Governance fora where ESG-labelled Products and Transactions are assessed?

Have we updated our Conduct Risk MI to capture Greenwashing?

Are our own staff suitably trained and incentivised to identify and advise on Greenwashing Risks, and are we bringing the entire Firm with us on that journey?

Are we conducting outcomes testing to ensure that the right ESG-outcomes are being provided to clients?

Are we proactively helping the Business meet Sustainable Finance Targets in a controlled manner and providing the right client outcomes?

We have also released a paper with AFME on the Role of Compliance in ESG



ESG and the Role of Compliance

November 2022

Appendix

In this case study we highlight 4 key areas where Compliance could help prevent Greenwashing

Scenario

The credibility of net zero pledges of banks that were involved in selling a green bond issued by an airport authority was questioned, due to environmental issues linked to the project funded, and an apparent contradiction between emissions reductions targets and support of air traffic growth

What went wrong

Mis-alignment between Firm Net Zero commitments and Financing activity

Deal either not escalated to governance, or unclear how it was approved

Labelling of Bond as Green given second order impact on the environment of air travel

Client assessment should have raised red flags

Compliance's role

Provide guidance in Environmental Policy on permissible activity given Firm commitments

Create governance structure, capturing all in-scope deals for review, and be active participant in challenge

Creation of taxonomy defining product and transaction characteristics to obtain Green labelling

Creation of ESG client risk scorecards, outputs of which would drive transaction assessment

In order to bring this to life, the below flow of a transaction illustrates some actions Compliance could take through an ESG-labelled transaction review

Flow	Deal Initiation	Creation of Deal Review Pack	Escalated Transactions Reviewed	Deal Review Quorum	Metrics and Reporting
<p>Process</p>	<ul style="list-style-type: none"> ➤ Definition of Sustainable Product agreed and codified within Policies and Procedures and cascaded to Divisions ➤ Deal team makes assessment, where required if product is Sustainable, the 2LoD Environmental and Social Risk Team provide guidance ➤ System tagging available to define ESG transaction, and manner of role e.g. ESG Underwriter, ESG Bookrunner, etc. 	<ul style="list-style-type: none"> ➤ A deal review checklist is provided to all market facing staff to consider if they are conducting an ESG-labelled transaction ➤ Checklist is globally consistent to drive standardisation and alignment ➤ Focus on appropriateness of KPI or Use of Proceeds (UoP) to the underlier; industry standards (e.g. LMA, ICMA, EU Taxonomy) used where possible with verification from SPO 	<ul style="list-style-type: none"> ➤ On an exception basis, a deal will be escalated to a deal review forum. A standardised meeting template is completed ➤ Completed meeting templates are then saved in central location for audit trail and ability to review number and value of ESG transactions completed 	<ul style="list-style-type: none"> ➤ Functional attendee list of ESG Deal Review Fora standardised across Divisions ➤ Attendees trained on ESG risk factors to consider, and supported BU SME knowledge of transactions and sectors to challenge appropriateness of KPIs and UoP ➤ Where escalation is required, clear routes into a more senior ESG Divisional Review Forum or into existing Firm Franchise Risk Committees exist 	<ul style="list-style-type: none"> ➤ Using system tagging at onset of the deal, metrics can be pulled to show the number and value of transactions completed ➤ Monthly ESG Steering Committee held with representation from Senior Management from ESG Deal Review Fora functions ➤ Thematic metrics provided to Steering Committee to review ESG market trends to support business decisions, risk factors to manage risk appetite and control violations
<p>The Role of Compliance</p>	<ul style="list-style-type: none"> ➤ Advise on the definition and characteristics of Sustainable Products and codify in Policies and Procedures ➤ Advise on the creation of Environmental Policy which determines permissible activity per Sector and associated timelines in order to meet Net Zero commitments ➤ Provision of training to the Business on the application of Policies and Procedures 	<ul style="list-style-type: none"> ➤ Creation of deal review framework and checklist, driving global consistency ➤ Provision of pre-approved market standards for the Business, including the use of ESG Ratings ➤ Dynamic advise to the Business through deal formation on acceptable practices 	<ul style="list-style-type: none"> ➤ Establishment and approval of Governance forums for enhanced ESG Product and Transaction due diligence ➤ Creation of Record Keeping processes for deal review templates and decisions 	<ul style="list-style-type: none"> ➤ Quorum member of Product / Transaction reviews, advising the Business on: <ul style="list-style-type: none"> • Suitability of client to transact with • Appropriate structure of the Product / Transaction to obtain ESG-labelling • Alignment with Firm ESG Commitments • Any global rules, regulations or market standards that may be violated by transaction 	<ul style="list-style-type: none"> ➤ Creation of key metrics to identify potential mis-conduct, e.g.: <ul style="list-style-type: none"> • Number of ESG related matters escalated to Governance • Number of non transaction related ESG matters escalated to Governance • Sales quality testing failures The number of escalations or whistleblowing activities related to ESG

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