Financial Services Leadership Summit

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FSLS

VIEWPOINTS

Toward more pragmatic approaches to ESG and climate transition

The environmental, social, and governance (ESG) agenda has demanded significant attention from financial institution boards and management teams in recent years—especially the environmental piece, with a particular focus on climate transition. Following strong statements and proposals from investors and activists in 2021, the shifting macroeconomic and geopolitical environment is leading to a reassessment of how ESG objectives can and should be pursued given the need to consider new concerns about energy security and how economic conditions will affect customers and employees.

At the Financial Services Leadership Summit on June 8–9 in New York, directors and executives from large financial institutions, regulators, and other subject matter experts discussed how the ESG agenda and approaches to climate transition are evolving in the face of changing macroeconomic and political circumstances, as part of a broader agenda about how financial institutions are meeting heightened stakeholder expectations. This *ViewPoints* synthesizes discussions held in advance of and during the summit and is structured around the following themes:[1]

- **ESG expectations are evolving**
- **Climate transition remains a primary focus for financial institutions**
- **Leaders must manage competing priorities and trade-offs**

ESG expectations are evolving

As important facilitators of economic activity through their financing and investment activities, some financial services leaders worry that the strong focus on ESG in recent years has risked ignoring practical realities and losing sight of how financial institutions can work with stakeholders and customers to develop pragmatic solutions. Now, in the current geopolitical and macroeconomic environment, there are signs the ESG agenda is rebalancing and evolving.

Reassessing "ESG"

Critics of ESG efforts have emerged on both sides of the cause. Some accuse financial institutions of greenwashing, making "unrealistic or misleading

claims, especially about their environmental credentials."[2] Regulators and law enforcement have been investigating allegations of corporate greenwashing in the US and Europe. Others contend that a dominant focus on ESG has minimized more pressing, near-term risks and traditional measures of financial performance. For example, in May, Stuart Kirk, then head of responsible investing at HSBC Asset Management, publicly claimed that stakeholders were causing his and similar institutions to spend too much time on climate change, which in his view was far from the top risk for investors or financial institutions in the near term.[3]

One summit participant quipped, *"The left say it is greenwashing, the right say it is 'woke.'"* In light of criticisms, many are questioning how best to refocus ESG, as broadly defined, on the more tangible elements of its component parts. In a report on the "reckoning" in ESG investing, an expert stated, "In an ideal world, ESG would disappear as an acronym … and we would find a better way of labelling the conversation."[4]

A more nuanced approach from institutional investors

"Investors are becoming more sophisticated, more nuanced in their approaches."

– Participant

In May, the leaders of some of the largest institutional investors, including Larry Fink from BlackRock and Tim Buckley from Vanguard, clarified their firms' stances on energy investments: Vanguard said it would neither stop new investments in fossil fuel projects nor end its support for coal, oil, and gas production, and BlackRock announced that it was likely to vote against most shareholder resolutions brought by climate lobbyists pursuing a ban on new oil and gas production.[5]

A participant described the *"wild ride"* that ESG investing has been on over the last two years, noting that *"2021 was a year like no other, with record support levels and passage rates of shareholder proposals and votes against directors"* related to a perceived failure to sufficiently support climate transition. In contrast, support for shareholder proposals in 2022 was down[6]—not, according to this participant, because support for ESG is waning but because *"investors are becoming more sophisticated, more nuanced in their approaches; they appreciate trade-offs, and they are no longer applying a one-size-fits-all approach to environmental and social proposals."*

One participant suggested ESG needed to remain linked to long-term value: *"We need to get back to the definition of what ESG actually is. ESG to me is a way of analyzing a security. It's not about fixing income equality. It's a set of data points and information which help us analyze and invest and generate outsized returns for clients over the long term."* As markets have corrected, some participants questioned whether flows to ESG funds, which have been able to generate good returns for investors in recent years, may slow, causing

further reflection on what qualifies as "sustainable" and how to measure value.

This rebalancing of the ESG agenda is unlikely to alleviate the time and attention boards commit to these issues, however. A participant predicted, *"Boards are going to have to go deeper. Under 'ESG,' you could put 30 different issues into that bucket. I see investors really zeroing in on the material issues,"* so those will require continued, enhanced board attention. A director observed, *"You think of the pendulum as swinging back to the status quo; I don't see it going back. We are seeing the growing pains of ESG, but the trend will continue."*

Climate transition remains a primary focus for financial institutions

"Boards are going to have to go deeper … I see investors really zeroing in on the material issues."

– Participant

One board chair stated, *"There is climate and there is everything else"* when it comes to ESG. The scale of transition, the massive reallocation of capital, and the expectations for financial institutions mean that developing climate transition strategies is an increasingly central challenge for boards and management teams of leading financial institutions. At the same time, investors, regulators, and other stakeholders are pressing financial institutions to disclose more information about how their businesses contribute to carbon emissions and how they plan to navigate the transition to a low-carbon economy.

Progress on climate reporting requirements

Climate and ESG-related reporting and disclosures have lacked comparability because of a litany of competing frameworks and standards. An executive noted, *"If you go back to the 1920s, you couldn't compare basic financial data. That's where we are. We want information in a standardized way so we can do something with it."*

Some participants expressed concern that excessive focus on perfecting climate data, metrics, and reporting could distract attention from the actions that financial institutions should take to have a meaningful impact on transition. Yet there remains almost universal agreement that reporting standardization is essential. A director said, *"It is chaos out there in terms of disclosure requirements. We need common reporting standards acceptable across Europe and the US. Right now, we are just throwing data out there."*

Significant regulatory action marked progress in climate-related reporting and disclosure in the first half of 2022:

> *"It is chaos out there in terms of disclosure requirements."*
>
> – Director

- **Securities and Exchange Commission (SEC).** On March 21, the SEC released a proposal for new climate-related disclosure requirements for public companies. The proposed rules mark the first instance of regulators in the United States requiring companies to disclose their climate risks, strategies for handling such risks, and relevant data such as greenhouse gas emissions.[7] Under the current proposal, the SEC expects companies to provide information about the oversight and governance of their climate-related risk, effects of climate risk on business strategy, and mechanisms for risk assessment and management, including details on net-zero plans and scenarios. Large companies must begin reporting information about their direct greenhouse gas emissions (Scope 1) and indirect emissions from purchased energy (Scope 2) in fiscal year 2023. Rules for Scope 3 emissions—those derived from activities from assets not owned or controlled by the reporting organization but that the organization indirectly impacts in its value chain—will be phased in over a longer period, with greater flexibility in reporting, including no third-party verification requirements; an exemption for smaller companies; and a safe harbor for legal liability for disclosures.[8]
- **International Sustainability Standards Board (ISSB).** On March 31, the newly formed ISSB proposed its first set of draft standards for how financial institutions will be expected to produce estimates for carbon emissions linked to loans and investments. Proposed standards also address companies' climate-related risks and opportunities, requiring them to consider modes of governance, strategy, and management in different climate scenarios. Companies will be expected to report how they would be materially affected by different climate-related events like sea-level rise, severe storms, and fires.[9]

> *"There is a real emphasis to get jurisdictions around the world to a global baseline."*
>
> – Industry expert

Participants welcomed these developments as a step toward harmonizing climate reporting and disclosure standards. Previous frameworks and standards like the Task Force on Climate Related Financial Disclosure (TCFD) and the Sustainability Accounting Standards Board (SASB) provided useful starting points, but they left room for interpretation and flexibility. A participant observed, *"This will drive increased harmonization in reporting in these areas.*

For so long, companies have been relying on voluntary reporting, like TCFD, which was helpful in improving alignment around climate reporting. The SEC has leaned on existing frameworks in drafting proposed rules, which is welcome by companies who have been leveraging those frameworks."

The ISSB standards could create a global baseline for climate reporting and disclosures. An industry expert said, *"There is a real emphasis to get*

"This will help financial institutions calculate their financed emissions. It will get better over time."

– Subject matter expert

jurisdictions around the world to a global baseline so investors can assess enterprise value. The ISSB set up a jurisdictional working group with China, Japan, the UK, the European Commission, and the SEC to coordinate. We are looking to get to a global standard that can be adopted by the various jurisdictions."

Participants did share some concerns, however, about aspects of these new requirements:

- **Scope 3 emissions reporting.** Scope 3 emissions are seen as the most challenging for all companies, but particularly for financial institutions, which need to account for financed emissions and even facilitated emissions. A participant said, *"For Scope 1 and 2, I am more confident around the numbers, which have historically been reported, and there are already generally agreed standards. Scope 3 is the real issue at hand here*." Another participant noted, *"There are concerns about getting the data on time to report. Lots of people are concerned about getting data from clients and vendors, so they can't report on it. Smaller companies are really worried; they don't have the staffing or resources to report*." A subject matter expert highlighted the value of standardization in addressing these concerns: *"Since all companies will be required to report, this will help financial institutions calculate their financed emissions. It will get better over time. Lots of organizations see this as a huge opportunity. The Big Four, consultancies, data providers are all putting out new products."*
- **Escalating litigation risk.** Mandating reporting on areas where the data, metrics, and assurance are immature risks creating a flood of lawsuits, particularly in the United States. As a result, some have called for additional safe harbor as the policies are rolled out, particularly around reporting related to Scope 3 emissions. One participant reported, *"Anecdotally, we are hearing of lots of concern about litigation around Scope 3."* The participant added, *"There is safe harbor on Scope 3, but it is not clear if the safe harbor extends to any assurance on Scope 3. This needs clarification from the SEC."*

"Net zero is a nice term, but it is likely unattainable."

– Executive

Lastly, while the efforts toward greater harmonization are appreciated, some participants remained skeptical about the likelihood of global agreement on a single standard. A director said, *"It would be very problematic if we wind up with two different standards.*"

Refining climate transition targets

> *"We want to know if your business model is resilient to climate change."*
>
> – Participant

While progress on climate reporting will be helpful, participants noted that climate transition planning remains in its infancy, with significant open questions about how long-term targets are being translated into credible plans. Some questioned the feasibility of net-zero targets altogether. One executive said, *"Net zero is a nice term, but it is likely unattainable."* A director said their institution struggled to *"come up with a net-zero plan that is credible"* because of the *"Herculean effort required to develop assumptions on things we have no control over."* While most see a role for policy in driving the climate transition agenda, participants were skeptical of leadership emerging from governments.

Participants discussed some of the steps their institutions are taking to advance the climate agenda:

- **Developing scenarios.** A participant said of net-zero planning, *"It's less about targets 28 years from now. It is more about, How will your portfolio perform against 1-, 2-, and 3-degree [Celsius] scenarios? You talk to modelers, it is not likely that we will hit 1.5-degree targets—so we want to know if your business model is resilient to climate change."*
- **Refining interim targets.** To make long-term targets credible, investors and other stakeholders are looking for greater detail around interim targets and the actions being taken to achieve them. A director said, *"Companies need to point investors to the key performance indicators along the way, around the things they think investors should focus on. There's an opportunity for companies to tell their story and show what people should be focused on."*

> *"The E and the S are in conflict. You've seen the doubling of energy costs."*
>
> – Participant

- **Shifting the focus to expanding sustainable finance.** Some participants suggested there has been excessive focus on risk mitigation and not enough attention paid to opportunities to advance sustainable energy and other green investments. A director said, *"The way I would characterize the problem is that all of the efforts are around risk mitigation—thinking about Scope 1, 2, and 3, decarbonization, greenhouse gases. There's not a reasonable conversation around investment. There is a much more sophisticated conversation around solar, wind, geothermal, nuclear, etcetera that needs to happen. We need to think about why those things are not working, rather than defund energy companies."*

Leaders must manage competing priorities and trade-offs

As macroeconomic and geopolitical complexities shift companies' priorities, financial institution leaders will have to manage competing stakeholder interests and trade-offs:

- **Navigating a shifting, sometimes contradictory, political and regulatory landscape.** *"There's such a fraught political environment. You have states that will penalize you for restricting fossil fuels,"* a participant remarked, referring to recent legislation in states like Texas and West Virginia threatening to cease doing business with companies that divest from fossil fuels.[10] A participant described the situation as one in which *"you are not the master of your own destiny—you are totally at the mercy of these externalities*," adding, *"That to me is a key risk."*
- **Balancing interconnected issues to ensure a just climate transition.** A participant decried the way some proponents of climate action *"operate in a manner that ignores the broader trends of how the world is actually functioning. The world is consuming 100 million barrels of oil a day. And there is a broader context here that 100 million people don't have access to energy."* The war in Ukraine highlighted the need to balance concerns about energy security, resiliency, and cost with climate transition objectives. As one participant noted, the priorities for energy provision are *"reliability and affordability."* Attempting decarbonization in the face of rising costs and shortages could pit social and climate objectives against each other: *"The E and the S are in conflict. You've seen the doubling of energy costs, and it's the ones most vulnerable who are most impacted."*

> *"There is no safe watering hole to have a safe conversation."*
>
> – Director

As financial services leaders manage these priorities within their boardrooms, they see room for improving coordination across stakeholders but worry about the ability to have honest conversations in a fraught political environment. *"There is no safe watering hole to have a safe conversation. What comes first with energy, economics, social, and climate change? I can't imagine that our CEO would feel safe having that conversation*," said one director. As these issues evolve, boards will need to consider the implications for policies, for governance structures and board composition, and for how their institutions engage with external stakeholders.

Appendix

The following individuals participated in these discussions:

Participants

- Homaira Akbari, Non-Executive Director, Santander
- Michael Alix, Americas Chief Risk Officer, UBS
- Jeff Barbieri, Vice President, Corporate Governance/ESG Research, Wellington Management
- Drew Barker, Senior Vice President, Head of Climate Risk Management, Truist Financial
- Richard Berner, Clinical Professor of Management Practice, Department of Finance and Co-Director, Volatility and Risk Institute, NYU Stern School of Business
- Sarah Beshar, Non-Executive Director, Invesco
- Howard Boville, Head of IBM Cloud Platform, IBM
- Jan Carendi, Non-Executive Director, Lombard International Assurance
- Bill Coen, Non-Executive Director, China Construction Bank
- James Cole, Non-Executive Director, AIG
- Kristen Dickey, Non-Executive Director, Somerset Re
- Dianne Dobbeck, Head of Supervision, Federal Reserve Bank of New York
- Beth Dugan, Deputy Comptroller for Large Bank Supervision, Office of the Comptroller of the Currency
- Eliza Eubank, Managing Director and Global Head, Environmental and Social Risk Management, Citibank
- John Fitzpatrick, Non-Executive Director, AIG
- Emily Gaston, Analyst, SASB Standards Financials Sector, Value Reporting Foundation
- Mike Gibson, Director of the Division of Banking Supervision and Regulation, Federal Reserve Board
- Jay Grayson, Chief Executive Officer and Co-founder, Surround Insurance
- Carlos Gutierrez, Non-Executive Director, MetLife; Chair and Chief Executive Officer, Empath
- Carlos M. Gutierrez, Chief Marketing Officer, Empath
- Bob Herz, Audit Committee Chair, Morgan Stanley and Fannie Mae
- Brad Hu, Executive Vice President and Chief Risk Officer, State Street
- Tim Keaney, Audit Committee Chair, Unum
- Sandra Krieger, Non-Executive Director, Deutsche Bank USA

- Joan Lamm-Tennant, Chair, Equitable Holdings and AllianceBernstein; Non-Executive Director, Hamilton Insurance Group
- Christine Larsen, Non-Executive Director, CIBC
- Marc Lindsay, Managing Partner and Director of Research, Sustainable Governance Partners (SGP)
- Nick Lyall, Non-Executive Director, USAA Savings Bank
- Michel Madelain, Non-Executive Director, China Construction Bank
- Callum McCarthy, Nomination and Compensation Committee Chair, China Construction Bank
- Tracy McKibben, Audit Committee Chair, USAA
- Dambisa Moyo, Co-Principal, Versaca Investments, Global Economist, Author, and Board Member
- Diane Nordin, Audit Committee Chair, Principal Financial; Compensation and Human Capital Committee Chair, Fannie Mae
- Gordon Orr, Non-Executive Director, Lenovo, Meituan, Swire Pacific
- Andy Ozment, Chief Technology Risk Officer and Executive Vice President, Capital One
- Marty Pfinsgraff, Risk Committee Chair, PNC Financial
- Chris Pinney, President and Chief Executive Officer, High Meadows Institute
- Bruce Richards, Vice Chair, Credit Suisse Holdings USA
- David Sidwell, Non-Executive Director, Chubb
- Nick Silitch, Senior Vice President and Chief Risk Officer, Prudential Financial
- Bob Stein, Audit Committee Chair, Assurant and Talcott Resolution

EY

- Jan Bellens, Global Banking and Capital Markets Leader
- Peter Davis, Americas Financial Services Markets and Solutions Leader
- Matt Handford, Principal, Climate Change and Sustainability
- Ed Majkowski, Americas Insurance Sector and Consulting Leader
- Isabelle Santenac, Global Insurance Leader
- Sophia Yen, Principal, Insurance Strategy and Innovation Leader, Financial Services

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- Eric Baldwin, Principal
- Tucker Nielsen, Principal
- Andre Senecal, Associate

About this document

About *ViewPoints*

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

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The FSLS is an annual meeting addressing key issues facing leading financial institutions. It brings together non-executive directors, members of senior management, policymakers, supervisors and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring and trustworthy financial institutions. The FSLS is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of FSLS discussions and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of senior management, advisers and stakeholders who become engaged in this leading-edge dialogue, the more value will be created for all.

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Endnotes

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of summit participants and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made by summit participants and guests.

[2] Harriet Agnew, Adrienne Klasa, and Simon Mundy, "How ESG Investing Came to a Reckoning," *Financial Times,* June 6, 2022.

[3] Madeline Bruder, "HSBC Banker Draws Fire After Accusing Policymakers of Climate Change Hyperbole," *Financial Times,* May 20, 2022.

[4] Agnew, Klasa, and Mundy, "How ESG Investing Came to a Reckoning," *Financial Times, June 6, 2022.*

[5] Agnew, Klasa, and Mundy, "How ESG Investing Came to a Reckoning," *Financial Times, June 6, 2022.*

[6] Lindsay Front, "Mixed ESG Support at Recent AGMs," *Agenda,* June 13, 2022.

[7] Securities and Exchange Commission, "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors," news release, March 21, 2022.

[8] Mark Segal, "The SEC Unveils Proposed Climate Disclosure Rules," *ESG Today*, March 21, 2022.

[9] IFRS, "ISSB Delivers Proposals that Create Comprehensive Global Baseline of Sustainability Disclosures," news release, March 31, 2022.

[10] Mose Buchele, "Texas and other states want to punish fossil fuel divestment," *NPR,* March 16, 2022.