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ESG strategies: UK regulators ramp up expectations

Key developments see regulators expand their demands from financial institutions, explain **Anthea Bowater** and **Maisie Heath**

The UK's financial regulators have been focused on climate risk and the transition to net zero for some time now, and progress has been steady. The Prudential Regulation Authority (PRA) set out its expectations early on for the way in which regulated firms manage climate risks, including the manner in which those risks are reflected in firms' governance, risk management, disclosures and scenario analysis. The PRA is now actively monitoring against those expectations.

In the meantime, the Financial Conduct Authority (FCA) has been concentrating on building trust in sustainable markets, including by issuing guidance on product areas it is particularly concerned about, designing a labelling and disclosure scheme to help promote transparency in sustainable finance products, and by monitoring the market for greenwashing. However, considering ESG-related developments over the last twelve months, it is fair to say that there has been a seismic shift in both regulators' expectations in relation to firms' strategies and the way that they are planning for the future – particularly on climate strategy, engaging with counterparties, transition plans and the integration of ESG considerations across a business.

Climate strategy key

Climate strategies are now central for financial institutions. While the original expectation was that firms would work to understand and identify climate-related financial risks, it is now that a firm's strategy takes into account those risks and responds to them, while also identifying opportunities. This strategy should be driven and carefully supervised by the board and senior executives.

In its "Dear CEO" letter to firms in October 2022 in relation to climate risk, the PRA indicated that boards and executives should now be able to demonstrate that they understand how their firm is integrating climate considerations into their business strategies, planning, governance structures and risk management processes, and also ensure that the climate strategy is coherent across the firm. It then went even further, emphasising that, where appropriate, in the context of managing climate risk, climate should be considered in advance of business and strategic decisions – highlighting that firms' climate strategies should be a driving force rather than simply an exercise in risk management.

Separately, Sarah Breeden, Executive Director at the Bank of England (BoE) and climate change lead, has also commented recently that although firms have made a lot of progress in the last few years, she had hoped to see stronger links at this stage between climate change and strategic decision making. Although she acknowledged that there were legitimate reasons for this delay, such as the pandemic and geopolitical events, the implication was that firms should prioritise climate strategy and thinking ahead to manage the transition and to identify opportunities along the way.

Counterparty engagement

In its October 2022 letter, the PRA indicated for the first time that firms should have a "counterparty engagement strategy" as part of their effective management of climate risks.

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Some financial institutions will have already begun to engage with their customers – especially those who took part in the climate biennial exploratory scenario (CBES) run by the BoE in 2021. The objective of that exercise was to test the resilience of a select number of financial institutions' and insurers' business models, and the financial system more broadly, to climate-related risks, and to assess the steps that needed to be taken to ensure resilience. The three scenarios tested prompted the financial institutions and insurers involved to assess their climate risks, including by engaging with their largest corporate customers to better understand their vulnerabilities to climate change. The BoE considered this to be a key component of the desired outcomes of the exercise. The second CBES took place last year.

The PRA's newly developed expectations for firms' counterparty engagement strategies were set out in its letter at a high level only. It made clear that firms should try to understand how their counterparties will look to manage climate exposures, for example by developing new products and services as they change the footprint of their business over time. The PRA noted that currently firms did not have a complete picture of their counterparties' exposures or their transition plans, and that the information was challenging to source. It acknowledged that some firms were already looking ahead and considering whether to exit particular customers or sectors, and how to manage any exits in an orderly manner.

Ms Breeden has also recently addressed this issue. She recognised that this is not something which will (or should) happen overnight; instead, she says that economy-wide emissions reductions will come about through this proactive engagement, and that decisions will be aligned to the transition over time – where there are efforts made to understand the needs of firms up and down the supply chain, and to have difficult discussions about steps to take to reduce emissions.

Transition plans

Financial institutions have, for some time now, been making public commitments on climate, and have also been making disclosures in line with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD).

Effective transition plans require careful planning, ►

and clear and measurable goals against which progress can be tracked. In 2022, HM Treasury launched the Transition Plan Taskforce (TPT), with its aim being the development of a “gold standard” for transition plans. It has produced comprehensive guidance on producing transition plans, and that guidance is still under consultation.

In many areas, the TPT’s guidance requires an extra layer of detail on top of what is recommended by TCFD. For instance, there are additional requirements to: (i) prepare GHG emissions reduction targets across Scopes 1, 2 and 3 and also to set interim targets; (ii) disclose the various metrics used to assess progress towards a specific target; (iii) disclose current and planned engagement with industry peers, governments, regulators and other entities; and (iv) disclose the role and responsibility of the board and its sub-committees in respect of the transition plan.

The FCA has indicated that the UK will move towards requiring transition plans across the financial sector, and the platform for it is there already – it has integrated the TCFD’s guidance on transition planning into its disclosure rules for listed issuers and regulated firms.

Despite the Chancellor announcing in 2021 that asset managers, regulated asset owners and listed companies would be required to publish net zero transition plans by this year, this timeframe appears to have slipped and work still needs to be done on the framework around transition plans and the standardised benchmarks against which they are to be measured.

Although the TPT’s guidance is still under consultation, the FCA clearly wishes to build momentum in advance of this guidance being finalised and of plans becoming mandatory. It has indicated that firms should use the current guidance published by the TPT to produce transition plans now, and that the FCA will set out its expectations on compliance once the finalised guidance has been published. There are risks in promoting this “have a go” attitude, without having set clear regulatory expectations – but it does demonstrate the importance that the FCA attaches to transition planning.

Integration of broader ESG considerations

Finally, the FCA has recently turned its attention to the integration of ESG considerations across firms’ businesses. Its recent Discussion Paper *Finance for positive sustainable change* looked to prompt a conversation on how regulated firms bring together sustainability considerations into their business, with a strong focus on governance arrangements, incentive structures and competencies.

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The Discussion Paper draws together some of the existing initiatives in the area, and then seeks specific feedback on a number of issues which will shape the FCA’s future regulatory direction. The FCA was keen to emphasise that the scope of the discussion extended beyond climate change, and covered wider environmental issues, such as biodiversity and nature, as well as social and governance issues, such as diversity and inclusion, the living wage, fair taxation and supply chains.[1] This was the first time the FCA has examined the topic of sustainability with such a broad lens.

From a strategy and planning perspective, the FCA made particular mention of firms’ public sustainability related commitments, saying that it expects firms to develop and articulate a credible strategy to deliver on these commitments.

The discussion period closed in May 2023, and the FCA is now considering industry feedback and its next steps. However, the discussion paper – and the lens it provides on the FCA’s broad areas of focus across sustainability – is a significant step-change in itself.

Many of the recent developments in regulators’ expectations in this article are likely to progress into much harder-edged and more prescriptive rules. In the meantime, financial institutions have the opportunity to meet expectations in the way that best suits them, as long as their strategies are cohesive and defensible in light of the information currently available.

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1. Finance for positive, sustainable change | FCA