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GREENING FINANCE - A UK ROADMAP TO SUSTAINABLE INVESTING

Governance, Sustainability & Society – Part of the Horizon Scanning series

Just before COP26, the UK government announced a number of sustainability and climate change-related policy plans, setting the tone for its negotiating position in the climate conference and beyond.

In addition to the UK's long awaited Net Zero Strategy (summarized here) and HMT's Net Zero Review of what the transition trade-offs will be, the Government laid out its vision for Greening Finance: A Roadmap to Sustainable Investing, which will have several key impacts on businesses and institutions of all sizes.

Four key proposals

The greening finance roadmap builds on pre-existing trends, including the push for increased climate-related disclosures, an emphasis on good stewardship of capital, and the pressure to have credible net zero transition plans.

At a high level, the proposals will mean:

- a new Sustainability Disclosure Requirements (SDR) regime that will require:
  - corporates (not just listed companies, although the exact scope is to be determined) to report under the International Financial Reporting Foundation's International Sustainability Standards Board (IFRS ISSB) global accounting standards once they are established, as well as on their environmental impact under the UK Green Taxonomy;
  - asset managers and asset owners to disclose how they take sustainability into account; and
  - creators of investment products to report on the sustainability impact of their products, as well as the associated financial risks and opportunities, forming the basis of a labelling regime for customers;
- the introduction of a mandate to produce transition plans aligned with net zero, currently on a comply-or-explain basis, although this may harden in light of feedback the Treasury has already received about this approach;
- continuing progress toward a UK Green Taxonomy with the help of the Green Technical Advisory Group, to provide rules for determining activities that can be labelled as 'green' for investment purposes; and
- an emphasis on net zero aligned stewardship of capital for pensions and the investment sectors.

The transition plans and approach to stewardship will in turn need to consider impacts on workers and the wider community in order to ensure a 'Just Transition', especially in high carbon sectors.

Corporates to report first

Corporates will be required to report under the SDR first and within two years of Royal Assent of the relevant legislation. Asset managers, asset owners and investment product reporting will follow shortly after, meaning the investment sector should have the information they need to be able to report effectively, and to do so under a single, more consistent system.

This sequencing should go some way to helping the UK avoid the issues that have dogged the EU's Sustainable Finance Disclosure Regulation regime.

Mandatory transition plans

The roadmap makes clear that the Government expects transition plans to become widespread, including for both public and private companies (mirroring in many ways the push we have seen in this year's AGM season from 'activist' shareholders). It is likely that in much the same way the TCFD was initially voluntary but is now spreading across the statute book, legislation and market expecations regarding transition plans will become harder over time too.

Since supply chain emissions will need to be factored into transition plans, businesses and others will look to impose obligations upstream and downstream of themselves, meaning everyone will need to consider the potential impacts. Seeking out best practice, relevant standards, and a template to follow is a good start.

What standards will be expected?

The question of what approach to adopt remains complex, with no clear winner so far. However, Government points towards the fact that the TCFD has now finalised their guidance on transition plans; initiatives like Climate Action 100+ and the Institutional Investors Group on Climate Change have done good work in this area; and the Glasgow Financial Alliance for Net Zero (GFANZ) is working to develop best practice guidance for transition strategies for the financial sector.

In addition, the Government's strong support for the upcoming IFRS ISSB standards, along with the desire to align with the EU's Green Taxonomy where sensible, should help minimise the risk of businesses having to make similar-but-different disclosures multiple times.

The UK's Green Taxonomy and greenwashing

The development of a UK Green Taxonomy will also help firms have a clearer sense of what is required, and help head off the growing concerns around "greenwashing" and the litigation to which it can lead.

Based on the EU's Green Taxonomy, the UK's Green Taxonomy will cover six environmental objectives[1], in respect of which activities will need to make a substantive contribution, do no significant harm, and meet minimum standards in order to be considered green. This will help set a baseline and offer investors a far clearer picture of what they are investing in.

The importance of stewardship

The roadmap also underlines the important role pensions, asset owners, asset managers and those that support them need to play as responsible stewards of capital. In practice, those bodies will need to:

- integrate ESG into investment decision-making;
- challenge investees on their strategies for long-term sustainable value;
- collaborate in order to escalate where needed; and
- be ready to vote against directors, corporate actions and resolutions that are inconsistent with net zero.

It goes as far as to say that, "in some cases, the exercise of stewardship discipline may eventually escalate to withholding capital or divestment. For example, where a company is not taking appropriate action to transition to net zero".

In fact, ABP, Europe's largest public sector pensions fund, offers a recent glimpse of things

[1] The activities are: climate change mitigation, adaption, sustainable water use, the circular economy, controlling pollution, and protecting biodiversity.

to come, having recently announced that it will divest from fossil fuels entirely by 2023.

What happens next

The Government describes the roadmap as phase 1 of a three-phase plan. This first phase focusses on giving investors and consumers the information they need to make sustainable investment choices. The second phase will focus on integrating that information into decision making. The third phase will look to shift financial flows so that they align with the UK's net zero ambitions and environmental goals.

Look out for an update to the Government's Green Finance Strategy in 2022, in particular, which will set indicative sectoral pathways, assess progress against phases 1 and 2, and look for ways to facilitate phase 3.

The precise timelines for domestic implementation of the roadmap are still uncertain but there is opportunity for the Government to make further announcements in the next few weeks and in light of COP26 about its intentions.

This is a big moment for corporates. Change will not be felt immediately as primary legislation will be required. However, they will still need to invest in systems to be ready to report on the basis of an enhanced-TCFD model in a short time frame, and stand behind what they disclose. So too for asset managers, owners and pensions not long after.

Jeff Twentyman

Partner

T +44 (0)20 7090 3476

E jeff.twentyman@slaughterandmay.com

George Murray

Senior Professional Support Lawyer

T +44 (0)20 7090 3518

E george.murray@slaughterandmay.com

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