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# Slaughter and May's banking and investment services column: March 2023

by Financial Regulation group, Slaughter and May

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The Financial Regulation group at Slaughter and May, including Nick Bonsall, Selmin Hakki and Emily Bradley, regularly share their thoughts with Practical Law Financial Services subscribers on topical developments in the banking and investment services sector.

In their column for March 2023, they consider the Bank of England's March 2023 report on climate-related risks and the regulatory capital framework, the FCA's February 2023 discussion paper on finance for positive sustainable change (DP23/1), the assessment and disclosure of Scope 3 emissions more generally and HM Treasury's February 2023 consultation paper on the UK regulatory approach to cryptoassets.

## A new piece of the climate risk and regulatory capital framework puzzle

Earlier this week, the Bank of England published a report setting out its latest thinking on the impact of climate risk on the regulatory capital framework.

Readers of this column will be aware that policymakers and regulators have been looking closely at this area for some time. There is a need, says the report, for yet more analysis before we see any policy change. In the meantime, prudential regulators will have to "form judgements on the extent that relatively unquantifiable risks are within their risk appetites and act accordingly to address them", which is likely to result in "a gradualist approach to policymaking as risk identification and measurement capabilities develop".

It is, however, possible to draw some conclusions about what this report means for firms in terms of short-term priorities. First off, addressing capability gaps should take precedence. Firms are not expected to have embedded an end-state framework for climate risk measurement at this time, but the regulator wants to see "continual progress and ambition". Firms should be able to explain how they are getting comfortable that any material climate risks are appropriately capitalised. Climate stress tests (including last year's CBES) have not yet formed a direct quantitative basis for calculating capital requirements, but firms should be continually improving their internal capabilities for using scenario analysis for climate risks.

Enhancing climate-related governance and controls should also be a top priority - this message was also clear in last year's Dear CEO letter to banks.

Some other points worth drawing out of the report:

- The Bank of England does not support an extension to the existing time horizons for setting regulatory capital for climate risk (which are typically one year). This would be a fundamental and unnecessary change to the framework, which is already used to manage long-term risks. Nor is it in favour of intervening to require firms to hold more capital against assets exposed to carbon-intensive energy sources, either directly or through a penalising factor. We've heard this message before, but the point will be kept under review. There's an explicit acknowledgment that an adjustment to the risk-weighted assets (RWA) framework might be justified where climate change affects the relative riskiness of assets, but there's to be no change for now because "the challenges here are extensive as data and models remain limited". The Pillar 2 framework, says the report, will be a key tool to address microprudential regime gaps within the existing regime, while policymaking discussions on gaps in the Pillar 1 framework take place internationally with the Basel Committee. And the PRA is already building an understanding of banks' evolving approaches to Pillar 2A capital add-ons through its business-as-usual supervision against the expectations in Supervisory Statement SS3/19.
- It is also noted that inaction, or a lack of clarity on the transition to net zero, might lead to a build-up of risks



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across the financial system that are not adequately captured by Pillar 1 or Pillar 2 capital requirements. This could justify the use of macroprudential tools in the future.

The overall message is this: substantial further work is needed and there remain many open questions, notably on potential regime gaps to capture systemic risks from climate change and unintended consequences. The Bank will continue to address these questions as part of its supervision and policymaking.

We look forward to reporting back on any future proposals to change the regulatory capital frameworks, which will be taken through the PRA's formal policymaking process.

## The regulatory foundations for sustainable change

Let's also look at the FCA's discussion paper on finance for driving positive sustainable change (DP23/1), published on 10 February and split into two parts. The first part tackles the role to be played by governance, incentives and competence in regulated firms if they are to contribute to the transition to a net zero economy. The second part comprises 10 commissioned articles from various experts to provoke "diversity of thought" and complement the FCA's own analysis.

It's easy to be cynical about the FCA's stated goal of stimulating "an industry-wide dialogue" on these topics. As is usual with discussion papers, DP23/1 contains no formal proposals. But it does suggest the likely direction of travel for regulatory expectations around governance, remuneration structures, training and competence over the coming years. In addition, by considering DP23/1, firms can help to turn what is sometimes a negative debate about ESG into an opportunity for positive development.

Some takeaways:

- Good governance, oversight and challenge, is critical. Firms that want to excel in this area should examine their committee and working group structures, management information systems and decision-making processes. The FCA has given some thought to introducing board-level champions (as is required under the consumer duty) for ESG.
- There's a strong sense that the FCA will be setting more specific regulatory expectations on the role of governing bodies in relation to sustainable products. It is also exploring the possible introduction of additional measures to encourage effective stewardship at asset managers.
- Many firms are already linking progress on sustainability-related commitments to a measurable proportion of executive pay. Firms may wish to consider performance measures for their wider workforce, though the metrics will need to be calibrated appropriately. Some things to think about when linking remuneration to sustainability objectives include weightings, short term vs long term measures, link to transition plans, and remuneration adjustments when targets are not met.
- Firms should be building relevant skills and capabilities across their organisations. The FCA is increasingly focused on how firms will ensure that staff at all levels of the organisation (not just the board) have the right expertise. Additional training and competence requirements may be on the horizon to guard against "competency-washing".
- The concept of a company's purpose features prominently. Although the FCA doesn't go as far as to prescribe what a firm's purpose should be, it does: "expect evidence of its commitment to achieving its stated purpose, including consistency in its messaging and its actions, and evidence of how its purpose is embedded throughout the firm."

## Tackling banks' Scope 3 emissions

As DP23/1 observes, "[c]ommitments on sustainable financing and financed emissions are increasingly where the action is at. For financial services, climate impact is generally in Scope 3… it is increasingly expected that firms include Scope 3 emissions in their targets".

The Greenhouse Gas Protocol, the most widely used corporate accounting standards for emissions, divides the greenhouse gas emissions of a company into three scopes. Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the generation of purchased energy. Scope 3 emissions are indirect emissions that are not owned or directly controlled but occur in the "value chain".

According to the Task Force on Climate-Related Financial Disclosure (TCFD), for banks, Scope 3 emissions are those associated with lending, underwriting, asset management and investing activities. In its financial sector specific guidance on net zero transition planning, the Glasgow Financial Alliance for Net Zero (GFANZ) recommends that firms:

> "… cover Scope 3 emissions associated with clients or portfolio companies in sectors that are significant climate change contributors or where company Scope 3 emissions are material and can be incorporated based on data availability."

Signatories to the Net Zero Banking Alliance (NZBA) are required to set targets that encompass Scope 3 emissions from lending and investment portfolios, but (as it stands) not other business lines, such as capital markets. The Science Based Targets initiative (SBTi) standard requires financial institutions to set and communicate target(s) that cover Scope 3 investment and lending activities.

This should come as no surprise, really, given that there are detailed guidelines for quantifying financed emissions from loans and investments (see the Partnership for Carbon Accounting Financials (PCAF), which has developed a standard for measuring emissions associated with six asset classes: listed equity and corporate bonds; business loans and unlisted equity; project finance; commercial real estate; mortgages; and motor vehicle loans). But these sorts of methodologies are still under development for other activities (PCAF guidance for measuring and reporting greenhouse gas (GHG) emissions associated with capital markets transactions is, however, expected shortly).

Getting a handle on Scope 3 emissions is likely to be a large undertaking, so a targeted approach that focuses on the most significant GHG-emitting clients in specific industries may be the most practical way forward. That said, firms that focus on specific business segments for which methodologies have been established run the risk of failing to factor in their complete environmental footprint.

The Bank of England referred to the difficulties in gaining a clearer picture on Scope 3 emissions in the results of the 2021 Climate Biennial Exploratory Scenario (CBES):

> "In order to produce better estimates of climate risks in their portfolios, banks and insurers will need to prioritise investment in their climate risk assessment capabilities, both by focusing on their internal modelling and data capabilities and doing more to scrutinise data and projections supplied by third-party providers (upon which participants have relied heavily to compile CBES submissions). The inability to capture appropriate and robust data in certain areas is a common limitation, which means many climate risks are only being partially measured. Examples of gaps include information about the location of corporate assets to permit physical risk assessment, and a lack of standardised information about value chain emissions relating to corporate counterparties."

How banks respond to these challenges may ultimately hamper or enable the creation of a more climate-friendly and sustainable economy.

## Crypto: the next chapter

On 1 February, HM Treasury published its much anticipated vision for the future financial services regulatory regime for cryptoassets. Comprehensive, detailed, and 82 pages long, this consultation paper and call for evidence brings some coherence to an historically fragmented regulatory approach.

The proposals are driven by the government's desire to deliver a level playing field between crypto and traditional financial services firms conducting the same activity, where possible. To this end, as we have written about, the government is seeking to integrate a number of new regulated or designated activities tailored to the cryptoasset market within the existing regime in the Financial Services and Markets Act 2000 (FSMA) where these activities seek to mirror, or closely resemble, regulated activities performed in traditional financial services. To the disappointment of some, a separate bespoke regime has been discounted on the basis that it fails to achieve regulatory symmetry between crypto and traditional financial services firms.

This turn away from a bespoke regime is made in spite of the fact that that there are contexts in which analogies between crypto and traditional finance start to unravel. Crypto activities such as mining and validation, as cited in the consultation, provide good examples of this. Decentralised finance or "DeFi" is also identified as a particularly thorny area for regulators in an accompanying call for evidence. Whether these corners of the cryptosphere will in fact disrupt HM Treasury's core design principle of "same risk, same regulatory outcome" remains to be seen.

Another immediate point is that the absorption of cryptoasset activities within FSMA heralds the phasing-out of the parallel pseudo-authorisation regime that currently exists for cryptoasset exchange providers and custodian wallet providers under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs 2017). Such firms will ultimately be funnelled into FSMA authorisation. While another regulatory hill to climb for those firms that are already MLR-registered, HM Treasury notes that the supervisory history of businesses will be taken into account during a "proportionate" authorisation process, and that ultimately a single authorisation process will bring regulatory clarity and support supervisory and enforcement processes. Certainly, from a practitioner's perspective, this is a welcome step towards a more coherent regulatory regime.

Finally, it is worth grasping the significance of HM Treasury's proposal to capture cryptoasset activities provided in or to the United Kingdom. This expansive approach is indicative of the jurisdictional challenges presented by a digital ecosystem which does not necessary take heed of borders. Even when subject to certain proposed exemptions and equivalence measures, the broad geographical reach of the proposed regime for cryptoassets remains striking, particularly its extension of the registration regime under the MLRs 2017 (which applies only to firms with a UK presence).

There is much, much more to be drawn from this consultation beyond these points, and we look forward to continuing the discussion.