Sustainable Finance – the EU Regulatory Response

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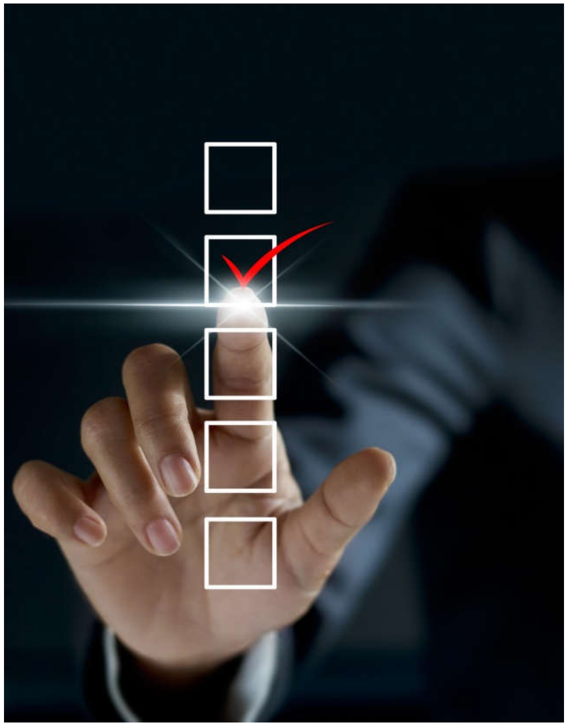
Key Takeaways



- Increasing international focus on sustainable finance: annual "investment gap" of €270 billion in environmental, governance and social investments (European Commission).
- Central banks are recognising the impact on financial stability posed by climate change and resource depletion
- New EU proposals to impose legal duties and disclosure requirements on institutional investors, asset managers and advisers
- UK regulators are consulting on initiatives to increase the flows of green finance and to require firms to recognise the effect of climate change on their prudential management

Background

2015 Paris Agreement on Climate Change

Vision to support change through removing regulatory barriers and developing new forms of regulation to support a changing economy – goal of mobilizing US$100 billion per year by 2020 for climate action in developing countries and additional pledges beyond that

October 2018 Intergovernmental Panel on Climate Change (IPCC)

Special Report on the impacts of global warming – $2.4 trillion investment needed in clean energy every year through 2035

2018 UK Clean Growth Strategy, Industrial Strategy

A 25 Year Environment Plan and launch of new Green Finance Institute

What is Sustainable Finance?

- Growing recognition of the likely impact of climate on the global economy and financial services / rising up the political and regulatory agenda.
- Increasing demand for "green" financial services and products.

Key Objectives:

- to improve the contribution that finance makes to sustainable and inclusive growth by funding society's longer term needs;
- to strengthen financial stability by bringing ESG considerations into investment decision making; and
- a third "financial stability" objective can be added over the prudential soundness of banking and insurance institutions

Regulatory

- European Commission Action Plan for Financing Sustainable Growth, March 2018
- EU's High Level Expert Group on Sustainable Finance
- EU legislative proposals, Spring 2018 (EU's Capital Markets Union (CMU) project)
  - ESG Taxonomy Regulation
  - ESG Disclosure Regulation
  - ESG Benchmark Regulation – low-carbon and positive-carbon benchmarks
- Commission Technical Expert Group on Sustainable Finance (TEG)

Regulation Policy Response

Three main aspects to the EU's legislative proposals to delivering sustainable finance:

01 | issuers of securities on regulated markets fulfilling their disclosure obligations including climate change risks;

02 | financial institutions having adequate systems and controls, together with governance, to manage the risks arising from climate change and to support the transition to a "low carbon" economy; and

03 | protecting consumers and market integrity by ensuring appropriate protection for sustainable finance products. Additionally, to see that innovation and competition are not unnecessarily impeded.

Commission Legislative Proposals

Who is affected and how?

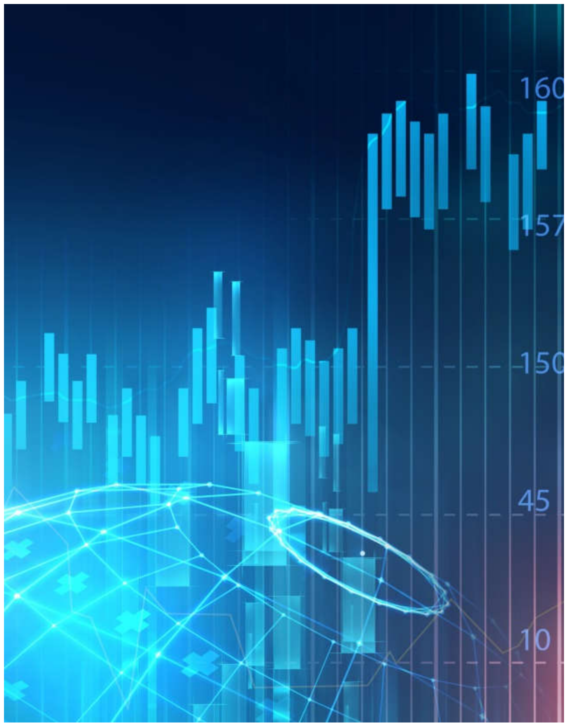
The Commission's legislative proposals apply to "financial market participants". These include:

- fund managers, including managers of alternative investment funds and UCITs;
- managers of venture capital and social entrepreneurship funds;
- institutional investors such as insurers and pension product providers; and
- potentially larger credit institutions that provide investment or credit risk-management processes (but not to their lending activities).

ESG Taxonomy Regulation

- To provide a harmonised taxonomy or "classification" system to help identify those economic activities that are environmentally sustainable
- To provide investors with EU-wide definitions on "what is green and what is not" – Commission Vice-President, Valdis Dombrovskis
- Reduce the practice of "green washing" – (i.e. the mis-selling of products as green or sustainable).
- Specifies the conditions that economic activities must meet to be categorised as environmentally sustainable and establishes screening criteria through binding rules.
- Direct effect in national law.

ESG Disclosure Regulation



- Existing EU directives and regulations protect investors by requiring appropriate disclosure to enable the making of informed investment decisions
- **BUT** disclosures to investors on sustainability risks, performance and investment targets in investment decision-making by fund managers and insurers are insufficiently developed
- Financial market participants will have to disclose (annually?) how they integrate sustainability into their investment and advisory processes and what impact they expect sustainability risks to have on returns
- Firms will have 12 months after the regulation is adopted this year to prepare for implementation

ESG Disclosure Regulation

Additionally…

Embedding sustainability factors

Asset managers, insurance companies and investment advisers must embed such factors in their organisational requirements, operating conditions, risk management and target market assessment (via amendments to existing financial services legislation e.g. UCITS Directive, AIFMD, MiFID2, Solvency II and the IDD).

Suitability

Investment advisers to expressly to include clients' ESG preferences when considering the suitability of potential investments (via amendments to the detailed rules under MiFID 2 and the IDD).

ESG Benchmark Regulation

- Amended Benchmark Regulation to create two new optional ESG benchmarks:
  - “Low-carbon" benchmark – a decarbonised version of a standard benchmark
  - A more ambitious, "positive carbon impact" benchmark – where emissions are removed
- Better understanding for investors of the carbon "foot print" of their holdings allowing comparison of their investments
- Benchmark administrators to retain flexibility in design as regulation applies minimum standards.
- Benchmark administrators publishing other types of ESG benchmark must explain approach to ESG.

Other Initiatives

TEG group developing a unified classification system for sustainable economic activities for corporate reporting and an EU Green Bond standard – a report will specify the criteria and processes that issuers should follow – and metrics for climate-related disclosures.

International Financial Reporting Standards	Revision of CRD IV and the CRR	Solvency II
(specifically IFRS 9) Concern not fit for purpose for sustainable investment decision making due to failure to properly reflect the long term ESG considerations.	Commission wishes to see environmental factors better reflected in prudential regulation.	EIOPA to provide an opinion on sustainability considerations by September 2019.

UK Initiatives

- FCA Discussion paper, DP18/8, on climate change and green finance (autumn 2018) – feedback due end January
- Bank of England paper on the impact of climate change on the UK's banking sector – boards to consider the paper and reflect on their current approach
- PRA's Supervisory Expectations, CP23/18, (October 2018) - firms should take a long-term view
- Climate Financial Risk Forum – to be established by PRA & FCA
- Brexit - ESG requirements likely to be important in any future equivalence assessment under MiFID II or EMIR to obtain access to the Single Market by UK and other third country firms.

What Should Financial Services Firms Do Now?

- Ensure products held out as ESG meet Taxonomy Regulation criteria – nb: ensuring that investments are green is one of sustainable finance's greatest challenges.
- Embed sustainability factors in their investment mandates, decision-making processes, risk management and target market assessments.
- Publish information on firm website over sustainability risks - explain how firm integrates such considerations into their decision making processes and include explanations of their ESG considerations.
- Ensure that ESG considerations are built into advisers' suitability recommendations and assessments and that investors have the opportunity to provide information on their ESG preferences.

What Should Banks and Insurers Do Now?

- If they have not already taken steps, make adjustments to their prudential management to take account of the impact of climate risk on their financial stability; and
- Expect supervisors (i.e. regulators) to place increasing emphasis on firms' exposure to climate change and related risks.

What does this mean for our clients

- Standardisation and transparency will steer capital towards compliant investments.
- Increased demand for investments which meet the required standards.
- Requirement for “green” investments to meet applicable standards.
- Increased regulatory burden for asset owners / managers.
- Focus on quality and level of disclosure for investments.

Regulation → Clarity / Transparency → Fund flow

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