Sustainable Finance

The European Regulatory Response to Environmental, Governance and Social Risk

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Takeaways

- There is increasing international focus over sustainable finance with the European Commission identifying an annual "investment gap" of EUR 270 million in environmental, governance and social investments.
- Central banks are recognising the impact on financial stability posed by climate change and resource depletion.
- New EU proposals have been tabled 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.

Introduction

On 8 October 2018, the Intergovernmental Panel on Climate Change (IPCC) released its Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways[1] undertaken in the context of strengthening the global response to the threat of climate change, sustainable development and efforts to eradicate poverty. The IPCC recommended that in order to limit warming to 1.5°C would require a roughly fivefold increase in average annual investment in low-carbon energy technologies by 2050, compared with 2015. This requires a USD 2.4 trillion investment in clean energy every year through to 2035 and a cut in the use of coal-fired power to almost nothing by 2050.

Furthermore, the World Bank Group has stated, "The financing required for an orderly transition to a low-carbon, resilient global economy must be counted in the trillions, not billions".[2] It has made clear that significant investment in infrastructure is needed over the next 15 years — around USD 90 trillion by 2030. Moreover, it stated, "Climate action offers a major opportunity to ensure sustainable global development and boost economic growth. It is already delivering real results in terms of new jobs, economic savings, competitiveness and market opportunities, and improved wellbeing for people worldwide with even greater investment, innovation, and growth potential ahead. The IFC estimates that the nationally determined contributions of 21 emerging market economies alone represent USD 23 trillion by 2030 in investment opportunities. Overall, a shift to low-carbon, resilient economies could translate into USD 26 trillion in global economic benefits through to 2030. Concessional climate finance is critical to supporting developing countries to build resilience to worsening climate impacts and to catalysing private sector climate investment".

Resolving these challenges will therefore require:

- new, innovative and at times highly disruptive technologies and approaches (renewable energy, batteries, electric vehicles, smart grids and smart cities, new processes like block chain and using satellites for data collection, water, transport (aviation, shipping and electric vehicles), climate smart agriculture and sustainable landscapes) and the investment in new infrastructure that supports such change and is increasingly resilient to climate change.
- governments committed to the 2015 Paris Agreement on Climate Change and with the vision to support such change through removing regulatory barriers and developing new forms of regulation to support a changing economy.
- financing this transition and driving such finance into the low-carbon economy but through a combination of public, private and philanthropic finance all working together.

It is within this context that the sustainable finance agenda has taken off around the world. The UN Environment Inquiry into the Design of a Sustainable Financial System to advance policy options to improve the financial system's effectiveness in mobilising capital towards a green and inclusive economy has found some 267 sustainable finance measures in 53 jurisdictions. In the UK, for example, since last October the government has finalised a Clean Growth Strategy, an Industrial Strategy and a 25 Year Environment Plan, and has also launched a new Green Finance Institute. The Bank of England has released a paper on climate change and the macro-economy, broadened its prudential supervision of climate risk to include banks and formed a network of central bankers for Greening the Financial System. The Clean Growth Strategy aims to "phase out the use of unabated coal to produce electricity by 2025".

Europe's agenda is more ambitious. The European High-Level Expert Panel on Sustainable Finance and the European Commission's Sustainable Finance Action Plan seek to steer capital towards sustainable investments and protect the financial system from sustainability risks like climate change. The Commission is also updating responsibilities for directors and fiduciaries in the financial sector and bringing in new prudential and reporting requirements.

What is sustainable finance?

As part of the Paris Agreement outcome, developed countries agreed to scale up their level of support with a concrete roadmap to achieve the goal of mobilising USD 100 billion per year by 2020 for climate action in developing countries and additional pledges beyond that. In addition, we saw the establishment of a dedicated USD 10 billion Global Green Climate Fund, which disburses grants and funds to climate mitigation and adaption. This has been complemented by the focus of development finance institutions and multilateral development banks on the Sustainable Development Goals, financing the development of cleaner energy systems through providing credit in the form of higher risk loans, equity positions and risk guarantee instruments to private sector investments in developing countries; and a new recent trend to establish new climate finance instruments in developing countries, namely National Green Development Banks, National Climate Trust funds and National Green Bonds.

In addition, there has also been a growing recognition of the likely impact of climate on the global economy and financial services that has risen up the political and regulatory agenda. Demand for "green" financial services and products has also increased. The Financial Conduct Authority states that there are now over 70 green bonds listed on the London Stock Exchange in seven currencies with a value of over USD 22 billion. There is also the phenomenon of "impacting investing". This refers to investments made not only to achieve a financial rate of return, but also to secure a measurable, beneficial or environmental impact.

According to the EU's High-Level Expert Group[3] — established following the Paris Agreement — sustainable finance has two 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 environmental, social and governance (ESG) considerations into investment decision making.

To these, a third "financial stability" objective may be added with regard to the prudential soundness of banking and insurance institutions. Both Mark Carney, the governor of the Bank of England, and Yves Mersch, an executive board member at the European Central Bank, have recently spoken on this issue. Taking note of the increasing effects of climate change, Mark Carney considers that financial stability risks to institutions will increase considerably if adjustments are not made to their prudential management. He recognises, however, that the majority of banks now treat the climate change risk as they do any other financial risk — in contrast with the approach until recently when it was seen as an aspect of corporate social responsibility.[4] Similarly, the ECB, besides the macro economic effects, is concerned that climate change can impair banks' financial stability.[5]

Sustainable finance — regulatory policy response

There are three main aspects to the EU's proposals to delivering sustainable finance:

- issuers of securities on regulated markets fulfilling their disclosure obligations, including climate change risks.
- 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.
- protecting consumers and market integrity by ensuring appropriate protection for sustainable finance products and, as a corollary, seeing that innovation and competition that can benefit the market are not unnecessarily impeded.

The Bank of England wants to enhance the approach taken by the Prudential Regulation Authority, its supervision arm, in scrutinising financial risks arising from climate change to promote the safety and soundness of banks and insurers. Additionally, it wants to improve the resilience of the UK financial system and see that financial institutions are better equipped to deal with the risks arising from the move to a low-carbon economy.[6] Separately, the FCA, which regulates the financial markets, has promised to consult on developing guidance for issuers on how the current regulatory regime under the Prospectus and Transparency Directives might be interpreted to include to climate change-related risks.

European Commission's action plan for financing sustainable growth

Increasing sustainable investment is a key part of the EU's Capital Markets Union (CMU) project and is a priority of the current European Commission, whose term ends on 31 October 2019.

Large public interest entities, i.e. companies admitted to trading on regulated markets, EU credit institutions and insurers, have been required by the EU's Directive on the Disclosure of Non-Financial Information ("NFI Directive") since the beginning of 2018 to disclose non-financial information, such as ESG, and how these risks are managed.

The Commission published an Action Plan for Financing Sustainable Growth in March 2018.[7] At a high level, it seeks to improve the quality of disclosure as well requiring investment advisers to take ESG considerations into account when providing financial products. Although the policy response to ESG has developed over a number of years, the unexpected success of the 2015 Paris Agreement on Climate Change has provided a significant impetus to both international and national initiatives. The EU's High-Level Expert Group report of January 2018 forms the basis of the action plan.

Why are these initiatives needed?

There are three reasons for the Commission's intervention:

- to redirect capital to sustainable investment where there is insufficient investment in ESG projects, thereby achieving greater "sustainable and inclusive growth". The Commission points to an "investment gap" of EUR 270 million a year identified by the European Investment Bank. It ascribes the problem, in part, to a lack of clarity among investors about what constitutes a sustainable investment. In the UK, the FCA is seeking to fill this gap by encouraging innovation in specialist green products, and also by means of a global sandbox initiative — the Global Financial Innovation Network or GFIN. The FCA is also setting the industry a "Green FinTech Challenge", calling on firms to develop new products and services to help the move towards a low-carbon economy.
- to manage the financial risks arising from climate change, the depletion of resources as well as "environmental degradation and social issues". The United Nations Environment Programme - Finance Initiative (UNEP FI) is a partnership with the financial sector to promote sustainable finance where participants must follow a Statement of Commitment.[8] It includes over 230 financial institutions (e.g. banks, insurers, and investors) that are working with the UN to understand ESG challenges, their importance to finance and how they can be proactively addressed. Banks and insurers will be exposed to greater losses in the future if their customers are less profitable due to climate change or reliance on finite natural resources. According to research cited by the Commission, almost 50% of the risk exposure of Eurozone banks is to climate change risk.
- to boost transparency and a "longer-term" view. Short termism is a perennial complaint about financial markets. Transparency on sustainability is seen as a precondition for investors properly understanding and pricing the longer-term value of companies, as well as assessing their management of sustainability risks. Pension funds are a good example, as the long-time horizons of such investments make climate change a material factor in their financial performance. A survey of the UK banking sector by the PRA has found that banks' planning horizons average only four years — a period too short for climate change risks to fully crystallise. In a reference to the work of groups such as the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), the Commission underlines its support for initiatives to improve the disclosure and accessibility of information in this area. The PRA, which has recently reviewed its firms' risk management framework, considers that the core elements of the TCFD's recommendations on climate-related financial disclosures around governance, strategy and risk management, together with metrics and targets, are consistent with its own for banks and insurers.

Commission's legislative proposals

As part of the Commission's action plan, legislative proposals were published in spring 2018.[9]

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.

This list may extend to larger credit institutions that provide investment or credit risk-management processes (but not to their lending activities) if an amendment by the EU Parliament is successful. Moreover, if and when the AIFMD passport is switched on for third countries, those AIFMs would also be caught.

The proposals draw on the UN Principles for Responsible Investment - Reporting Framework, and the OECD's Guidance – Responsible Business Conduct for Institutional Investors – Key Considerations for due diligence under the OECD Guidelines for Multinational Investors (2017).

ESG Taxonomy Regulation

As a regulation, this proposed legislation will have a direct effect on national law and is intended to provide a harmonised taxonomy or "classification" system to help identify those economic activities that are environmentally sustainable. In the words of Commission Vice-President Valdis Dombrovskis, it will provide investors with EU-wide definitions on "what is green and what is not".[10] The aim is to facilitate sustainable investment choices by market participants and reduce the potential for confusion among investors, given the variety of existing market-based initiatives and national practices. It will help tackle the practice of "green washing", i.e. the mis-selling of products as green or sustainable.

Currently, no such taxonomy exists at the EU level and the Commission believes that market-led initiatives, while helpful, have not made much impact. The regulation will work in two stages, first by specifying the conditions that economic activities must fulfil in order to be categorised as environmentally sustainable. In this regard, it will define six EU environmental objectives against which they must be assessed. Secondly, it will work by establishing screening criteria through binding rules — here drawing on advice from the Commission's Technical Expert Group on Sustainable Finance (TEG). Firms will have six months after the screening criteria enter into force to prepare. In due course, the scope of the regulation may be extended beyond solely environmental concerns to, for example, social factors. This may open a divide between investments satisfying the new regulatory criteria and historic green investments.

ESG Disclosure Regulation

Existing EU directives and regulations protect investors by requiring appropriate disclosure, and thereby enable informed investment decisions to be made. While this objective has been largely achieved for mainstream financial risks, disclosures to investors on sustainability risks, performance and investment targets in investment decision making by fund managers and insurers are insufficiently developed. Often, this is due to divergent standards or simply a lack sustainability performance indicators and requirements.

The regulation requires financial market participants to disclose, most likely annually, how they integrate sustainability into their investment and advisory processes and what impact they expect sustainability risks to have on returns. Trialogue negotiations are likely to begin between EU Parliament and Council of Ministers in January 2019.

The Commission also intends for asset managers, insurance companies together with investment advisers to embed sustainability factors in their organisational requirements, operating conditions, risk management and target market assessment. This will be done through amendments to existing technical standards under the UCITS Directive, AIFMD, MiFID2, Solvency II and the Insurance Distribution Directive (IDD), or alternatively through fresh technical standards. ESMA and EIOPA have been advising the Commission. Legislative proposals were published on 4 January 2019. Rules might also be made under IORP II, the recently revised EU pension fund directive.

Investment firms and insurance distributors can only provide products to customers that are suitable for them. This means that they have to perform "know your customer" due diligence, for example, obtaining information about their customers' circumstances and investment objectives. In the future, investment advisers will explicitly need to include clients' ESG preferences when considering the suitability of potential investments. This will require amendments to the detailed rules under MiFID 2 and the IDD. More immediately, ESMA has been asked to cover sustainability when it next updates its guidelines to firms on suitability.

Firms will have at least 12 months after the regulation is adopted next year to prepare for implementation. The TCFD is already driving change.

ESG Benchmark Regulation — low-carbon and positive-carbon benchmarks

A new type of ESG benchmark is to be created by amending the Benchmark Regulation. This has been designed by the TEG group. It will be a key tool to counter the practice of greenwashing described above. There will be a "low-carbon" benchmark — a decarbonised version of a standard benchmark — and a more ambitious, "positive carbon impact" benchmark — where emissions are removed. These will give investors a better understanding of the carbon "footprint" of their holdings allowing a comparison of their investments against these criteria. Benchmark administrators will retain some flexibility in their design, given that this regulation only applies minimum standards. Where benchmark administrators publish other types of ESG benchmarks, they will need to explain their approach to environmental, social or governance considerations. The EU Parliament is currently scrutinising the legislation.

Where no EU low-carbon or positive-carbon benchmark is available, financial market participants will have to explain how they intend to adhere to the goal of reducing carbon emissions.

What to expect in the year ahead

In the short term, the European Supervisory Authorities will support the implementation of the Commission's action plan by providing guidance to the financial services sector. They are also to help identify and report on the sustainability risks posed to financial stability, perhaps by developing a methodology that could evolve into a form of environmental stress testing. In due course, the Commission intends to bring representatives from the public and private sectors together under a governance platform. This would have the task of monitoring and taking forward the plan as well as providing the Commission with ongoing advice.

What else is happening?

In similar vein, the TEG group is developing a unified classification system for sustainable economic activities for the purposes of corporate reporting, an EU Green Bond standard — a report will specify the criteria and processes that issuers should follow — and metrics for climate-related disclosures.

There is concern that the International Financial Reporting Standards — specifically IFRS 9 — are not fit for purpose for sustainable investment decision making. This is because IFRS 9 does not properly reflect the long-term considerations that are inherent in ESG investments. In this respect, the Commission wants to ensure that the IFSR is at least neutral and does not act as an impediment to sustainable, but longer-term investment. The European Financial Reporting Advisory Group reported and made recommendations in November 2018 on the potential effects of IFRS 9 on long-term investments in equity instruments.[11]

More generally, the Commission plans to carry out a "health check" of public corporate requirements, including the NFI Directive. These are likely to be finished by the second quarter of 2019, with any necessary legislation brought forward by the new Commission after the EU parliamentary elections in May.

Given the importance of banks, insurers and pension funds to financing business, the Commission wishes to see environmental factors better reflected in their prudential regulation. It is looking at whether capital requirements under CRD IV and the CRR should be revised — in tandem with the phasing in of the ESG Taxonomy Regulation. These considerations will colour its assessment and implementation of the Basel recommendations of December 2017, the so-called "Basel IV". For insurers, EIOPA is to provide an opinion on sustainability in the context of Solvency II by September 2019.

Impact assessments in respect of climate risk on new infrastructure projects have been usual practice for many years, but investors are increasingly going further by seeking to anticipate future risks and standards by building in added resilience. In this context, the Equator Principles is a risk management framework used to assess and manage ESG factors providing minimum standards for due diligence and monitoring.[12] Project finance consultants use it across project finance. Member financial institutions are committed to implementing these principles, as are multilateral development banks and export credit agencies.

UK developments

The FCA published a discussion paper in autumn 2018 on climate change and green finance, which is open to feedback until the end of January 2019.[13] Similarly, the Bank of England has published a paper on the impact of climate change on the UK's banking sector. It expects boards to consider the paper and reflect on their current approach. A consultation on PRA's supervisory expectations (CP23/18) was published in October 2018 focusing on how governance, strategy and risk management frameworks should take account of the financial risks deriving from climate change. This will include an expectation that firms should take a long-term view.[14] Similar to the Commission's plans, the FCA and PRA intend to establish a Climate Financial Risk Forum to involve all relevant stakeholders, ranging from private firms to public bodies, to develop approaches for assessing, managing and responding to the financial risks from climate change.

What about Brexit?

The legislative proposals in the Commission's Plan are expected to be adopted and to come into effect during any transition period; this is likely to run until 31 December 2020 (although it is capable of a one-time extension). In any event, whether there is a Brexit transition period or a "no-deal" Brexit, compliance with ESG requirements are likely to be an important part of any future equivalence assessment under MiFID II or EMIR to obtain access to the Single Market by the UK and other third-country firms. More fundamentally, as sustainable finance is driven to a large extent by international initiatives, the UK will almost certainly continue to develop policy and regulatory standards in this area.

What should firms be doing now?

All firms in the financial services sector should:

- take note of the growing demand for sustainable investments and new products (e.g. green bonds) on the market.
- seek to take a longer-term view of investments in particular, with respect to sustainable finance investments.
- consider whether existing planning horizons are sufficiently long to evaluate the impact of climate change risks and when they might crystallise.

Institutional investors, asset managers and investment advisers should, as applicable:

- ensure where they are held out as such that ESG products meet the criteria in the Taxonomy Regulation. Ensuring that investments are green is one of sustainable finance's greatest challenges. If the regulation is successful, it would be an important step forward. The Commission's TEG is charged with the difficult task of drawing up a system of classification and is currently consulting with the sector on selected economic activities and proposed criteria.
- to the extent they are not already doing so, embed sustainability factors in their investment mandates, decision-making processes, risk management and target market assessments.
- publish information on their website concerning sustainability risks, explaining how they integrate 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.

The TCFD has developed voluntary, consistent climate-related financial risk disclosures for companies to provide information to investors, lenders, insurers and other stakeholders. The EU legislative proposals build on these. It is vital that boards fully engage in their implementation.

Banks and insurers should:

- 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.
- expect supervisors (i.e. regulators) to place increasing emphasis on firms' exposure to climate change and related risks.

Sustainable Finance Time Horizon	
EU High-Level Expert Group on Sustainable Finance - final report	31 January 2018
European Commission Action Plan on Financing Sustainable Growth	March 2018
EC ESG Legislative Proposals	24 May 2018
PRA Report: The Impact of Climate Change on the UK Banking Sector	September 2018
FCA DP18/8: Climate Change and Green Finance	15 October 2018
PRA CP23/18: Enhancing Banks' and Insurers' Approaches to Managing the Financial Risks from Climate Change	15 October 2018
FCA Approach Document to Climate Change and Green Finance	2019
European Commission legislative proposals published - financial market participants and insurers to consider sustainability when giving investment advice	4 January 2019
ESMA Update Suitability Guidelines to include Sustainability Considerations	Quarter 1 2019
ESMA/EIOPA Technical Advice on Incorporating ESG Factors into Client Duties	By 30 April 2019
ESG Disclosure Regulation – 18-month transitional period after entering into force	Early 2021?
Report of the Commission Technical Expert Group on a Standard for Green Bonds	Quarter Two 2019
Conclusions over Fitness Check on Public Corporate Reporting	Quarter Two 2019
Incorporating Sustainability in Prudential Requirements - CRD IV / CRR	2018-19
EIOPA Opinion on Sustainability in the context of Solvency II for Insurers	by September 2019

[1] See the Decision of the 21st Conference of Parties of the United Nations Framework Convention on Climate Change to adopt the Paris Agreement.
[2] See http://www.worldbank.org/en/topic/climatechange/overview [accessed 10 January 2019].
[3] EU High-Level Expert Group on sustainable finance - Final Report, January 2018.
[4] Speech by Mark Carney, governor of the Bank of England, on sustainability, 21 November 2018.
[5] Speech by ECB Executive Board member on sustainability, 27 November 2018.
[6] PRA Report: The Impact of Climate Change on the UK Banking Sector.
[7] European Commission Action Plan on Financing Sustainable Growth, March 2018.
[8] UNEP Statement of Commitment by Financial Institutions on Sustainable Development.
[9] European Commission Legislative Proposals, May 2018.
[10] Vice-President Valdis Dombrovskis, Keynote Speech, Sustainable Finance, 26 November 2018.
[11] EFRAG publishes technical advice on IFRS 9 to the European Commission, 30 November 2018.
[12] See https://equator-principles.com/about/ [accessed 10 January 2019].
[13] FCA Discussion Paper DP18/8: Climate Change and Green Finance.
[14] PRA Consultation Paper CP23/18: Enhancing Banks' and Insurers' Approaches to Managing the Financial Risks from Climate Change.