EPFSF Briefing on
"'CMU Sustainable Finance"
11 July 2018

Introduction

According to the European Commission, "Sustainable finance generally refers to the process of taking due account of environmental and social considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities". Sustainable finance has quickly evolved from being predominantly a reputational consideration to a long-term macro-financial lever. Following this evolution, specific questions are now asked on: how to classify sustainable financial assets; how to measure risks, opportunities and impacts; how to obtain resources for mitigating their impact; and how to carry out the transition to a low-carbon economy to be less dependent on polluting energy sources and promote clean ones.

A transition to a sustainable economic model requires large-scale investments in the economy. In order to achieve the UN Sustainable Development Goals, it is estimated that by 2030, €4.7 to 6.7 trillion of annual investments in sustainable infrastructure are needed. In the climate and energy space alone, it is estimated that the EU has to close an annual investment gap of almost €180 billion to meet its climate and energy targets by 2030.

Full coordination between public and private sectors is therefore needed, at all levels. Closing this investment gap requires the financial sector to play a role, primarily by helping to reorient capital flows towards a more sustainable economy. EU policy makers, jointly with supervisors and regulators, also have a prominent role to play in designing an appropriate regulatory framework and a suitable incentive system that promotes sustainability, does not hinder economic growth and supports financial stability. All these are needed for mainstreaming sustainability considerations into risk management and fostering transparency and long-termism in finance.

The case for EU leadership

Since the adoption of the UN Sustainable Development Goals (SDG) and the Paris Agreement on Climate Change in 2015, we have seen significant initiatives emerging: notably the recommendations of the FSB Task Force on Climate-related Financial Disclosures (TCFD) -and the subsequent UN pilot project to implement these recommendations-, the Network of Central Banks and Supervisors for Greening the Financial System, and important steps at EU level such as the European Parliament resolution on sustainable finance and the Commission's Action Plan on financing sustainable growth, based on the recommendations of the High Level Expert Group on sustainable finance. There are also initiatives promoted by the market with new standards, including Green Bond Principles, Social Bond Principles or Green Loan Principles.

This highlights that: a legal, regulatory and supervisory framework will be put in place to provide stability and certainty throughout project lifetimes. This will allow providers and recipients of financing to take a long-term sustainable standpoint in financial decision-making; additionally, there is a key opportunity for the EU to assume a leadership role in the global sustainable finance agenda.

It is important to underline that under the existing regulatory framework, climate-related risks are or can already be reported

by companies, investors and banks in various ways, sometimes as part of their wider corporate reporting. Companies raising finance on capital markets are generally required to file a prospectus, which will contain a description of the specific and material risk factors associated with the company and the securities. Climate risks could be disclosed where appropriate, as part of the issuer's specific and material risks. In the EU, the relevant legislation is the Prospectus Directive, which is currently being revised as part of the CMU. Furthermore, companies are required to report ESG matters. In the EU, large companies are required to comply with the Non-Financial Reporting Directive and listed companies may have additional reporting requirements. For example, they are subject to the Transparency Directive requiring large listed companies to report ESG data. Manufacturers of packaged retail and insurance-based investment products with environmental or social objectives are likely to have to disclose more details in KID.

The revised Shareholder Rights Directive requires both institutional investors and asset managers to explain, in their engagement policy, how they monitor investee companies on ESG matters. Institutional investors should also disclose how their arrangements with asset managers provide incentives on the latter to make investment decisions based on long-term non-financial performance of issuers.

The Action Plan on financing sustainable growth and its implementation

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The purpose of the Action Plan on sustainable finance is to build a sustainable finance strategy at EU level. To this end, the Plan outlines 10 actions organized around three overarching objectives which are reorienting capital flows towards a more sustainable economy, mainstreaming sustainability in risk management and fostering transparency and long-termism in the financial system. The legislative proposals released on 24 May by the European Commission follow up on the Action Plan on financing sustainable growth and represent the first step towards truly embedding sustainability in the EU financial system.

Specifically, the Commission's proposals have four main goals:

i. Create a single EU classification (taxonomy) for sustainable economic activities to enable all actors to speak the same language and to identify which practices have stronger or weaker sustainability profiles;

ii. Foster disclosure through the provision of information on the integration of ESG factors in the investment decision-making process;

iii. Establish two categories of benchmarks: low-carbon benchmarks and positive carbon impact benchmarks.

iv. Integrate ESG criteria into financial advisory services in accordance with clients' preferences.

As part of its work on implementing the action plan on sustainable finance, the Commission set up a Technical Working Group on Sustainable Finance in spring 2018, involving representatives of the financial industry, together with members coming from civil society and academia. Specifically, the group will assist the Commission with the development of EU taxonomy of climate change mitigation, climate change adaptation and other environmental activities, as well as an EU Green Bond Standard and other climate-related metrics. A workable and successful taxonomy will only emerge from a consensus from a wide range of market professionals. Sustainability experts including from sell-side, buy-side and other market participants such as credit rating agencies and lawyers could only adopt a Taxonomy if commonly agreed upon and correctly implemented. In this regard, there is a need for a flexible taxonomy than can evolve over time and which will be valid for all the sectors. It is therefore vital for such commonly agreed and implemented taxonomy to result from regular conversations, inputs and comments from a wide range of financial market participants and sustainability experts.

Considerations by the financial sector

Significant progress towards sustainable development has been made in the last two years. From a financial sector perspective, some key issues should be considered.

Linking financial sustainability to prudential regulation is an ongoing debate which needs to be carefully and comprehensively assessed to avoid unintended consequences on investment and financing decisions. Currently, EU regulation for financial services has a strong risk-based rationale for measuring capital. In this context, one of the issues is whether there is an economic rationale for supporting either incentivising or penalising factors to adjust capital for sustainable and non-sustainable investments respectively. Further work in the EU prior to any recalibration of prudential measures to ensure that capital frameworks can still achieve financial stability aims is key. A justification for a differential prudential treatment of sustainable investments would need to be based on evidence from robust and non-ambiguous empirical analysis supporting the case for real lower or higher financial risks.

It is key that an adequate disclosure mechanism that provides value added to investors and helps them in their expectations management is put in place. An important element in the current debate revolves around the necessity for transparency, risk measuring and comparability of the investment information that a common taxonomy needs to address. The role and the influence of sustainability data providers on information quality should also be further investigated. These issues need to be prioritised before envisaging any capital add-ons linked risks and capital planning as substitutes for instead of applying a market discipline approach.

Another important challenge is involving EU citizens in this financial sustainability path. The EU and Member States should explore tools to rebuild trust in the financial system and create demand for sustainable investment at retail level. The promotion of financial literacy would be a key lever in this regard.

Additionally, sustainability offers large opportunities in terms of product design. An example is blended finance, which aims at blending together traditional investors and philanthropic capital. Another great opportunity to expand the investor base is the development impact bonds via the use of tranches that can better serve the needs of traditional investors while attracting new capital from the private sector.

Last but not least, the enormous potential of digitisation for bolstering sustainability has to be explored.

Conclusion

Sustainable finance can improve EU citizens' social welfare and have a positive effect on the real economy by promoting innovation, job creation and economic growth. The EU has made significant steps towards making our economy and society more sustainable and is willing to take on a leadership role in this respect. It is now essential that, once implemented, sustainable measures will be efficient and effective in reaching their respective objectives.

Sustainable finance is becoming the new norm in finance. However, sustainable investments need to be economically viable and profitable if they are to be financed by the private sector. The Commission has taken an important first step in this direction by introducing the bases for a clear classification of sustainable products and activities which will need to be consistent and dynamic over time. Hopefully, this will enable to generate the necessary data for assessing the link between performance measurement and sustainability as well as an easier comparison of different investment opportunities, which in turn will allow further analyses/incentives to be explored.

Considering the urgency to act on sustainability issues, it is paramount to promote collaboration between all stakeholders and continue efforts if we want to achieve the transition to a low-carbon economy and achieve the objectives of the CMU.

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