SUSTAINABLE FINANCE LEGISLATIVE PROPOSALS

1. European initiatives on sustainable finance

1.1. This is a problem with enormous time pressure and scope

A speaker from the public sector stressed that sustainability is extremely serious, noting the strong commitment from young people on this issue. Climate change might soon become irreversible, so it is essential to tackle this issue seriously and without excessive pessimism. The speaker evoked the creation by the Banque de France of a network of Central Banks and supervisors with participation from over 30 countries. An official noted that the amount of additional investment needed to cope with the commitments made in the Paris Agreement is estimated to be between €200 billion and €300 billion. Finally, the window to do this in, is approximately 10 years. The world needs a substantial quantum of money, and it needs a consistency of action between public and private-sector funding.

An industry representative agreed with these remarks, noting that it is a testament to the timeliness and importance of the topic that Eurofi has scheduled three sessions on the subject. Another industry representative disagreed, suggesting that the scale of the problem is such that every panel should be on sustainable finance. A third industry representative suggested that the discussion on sustainable finance should permeate every discussion in the industry. Other panels discuss economic growth as if it exists in isolation, but life on earth is at stake. An official agreed that the problem of climate change is a problem of time. There is enough scientific evidence to suggest that the world is already constrained by time to the extent that it must act now to ensure climate change is not irreversible.

1.2. The work of European regulatory and supervisory authorities

An official considered that the role of public authorities is precisely to strike the balance between understanding the seriousness of events and becoming excessively complacent by thinking that the 'cavalry of technology' will solve these problems.

Public authorities must raise awareness of these issues among the community of regulators and supervisors and outline the taxonomy of risks associated with climate change. Indeed, having the right taxonomy and the right description of these risks enables the market to understand whether these risks are properly priced, for example. If there is an excessive concentration of climate events in a particular region or a particular period, this will impact insurance companies and banks. The balance sheets of affected institutions will also have an effect on global financial stability due to the size of these events.

If there is a taxonomy as well as a good description of these risks and a way to improve the pricing of risk, the industry can begin to prevent them. The official felt that work cannot only be done on the prevention side. If the industry works in this direction at the global level and at the level of local regulators, the world might overcome the so-called tragedy of the horizon[1].

1.3. Private initiatives: moving capital in the right direction

An official felt the marriage between climate and finance is not the most obvious one. One way to rationalise it is the existence of big climate risks, which in finance means big returns. An industry representative described how the green bond market developed. The market is up 17% on where it was at the same time last year, and there are clear benefits to having a clear taxonomy that enables product development. The industry speaker described how their institution has developed 11 different products on the basis of this taxonomy. As an example, this institution is able to cross-match the energy-performance certificate data of 27 million UK homes with their own back book. Through the use of defined standards, this institution is able to identify the part of the asset class which is less likely to default. More energy-efficient homes are less likely to default than comparatively less energy-efficient homes. This enables the institution to reflect this in the pricing for this product. Data and sources are an extremely pertinent issue in the debate over sustainable finance.

Another industry representative outlined how their own institution joined the UN Sustainable Stock Exchanges Initiative in 2012. When Sweden established the market for sustainable bonds in 2015, it was the first market of its kind on the planet, handling the environmental, social and governance aspects of sustainable finance. The industry representative welcomes the Commission's Action Plan on Sustainable Finance. However, the entire finance industry must do more and stay ahead of the regulators. This is easy for the Nordic countries, because they are very strong on ESG reporting and transparency. The industry representative described how their institution introduced ESG reporting in 2017, noting that the company is planning to do something 'extraordinary' within the next 4-6 weeks by launching its ESG Reporting Guide 2.0 as a global recommendation for listed companies. Their institution is pushing the envelope with respect to sustainability. First, it has introduced ESG indices on its benchmark indices in the Nordic countries. In Sweden, it has also introduced an ESG index future. Institutional investors in particular can use this derivative to handle their exposure to the Swedish market with an ESG-filtered index, which excludes non-ESG companies. This year the institution is going to launch support for impact investing portfolios in terms of clearing services for tailor-made baskets of stocks.

Another industry representative considered that the industry is 'learning by doing'. Some investors do not feel they are receiving sufficient information. A period where these things are voluntary is certainly helpful as the industry works together to solve these problems. Eventually these instruments and requirements will become mandatory, but a period of voluntary experimentation is essential.

2. The European Commission's proposals on taxonomy

2.1. The development and functioning of the taxonomy

An official outlined the work currently being undertaken by the European Commission. On the public side, the European Commission is engaging European money. The two big initiatives of the EU are the Multiannual Financial Framework and investEU. Europe has streamlined sustainable finance all over this framework. It constitutes about 25% of the expenditure, which is approximately €40 billion a year. investEU is a policy which uses small public investment to entice private investment, and also gives considerable prominence to sustainable investment. It is important that the public side should be there in terms of money and as a signal that the European authorities believe what they say, but the private sector must provide the bulk of the money.

The Commission is also attempting to ensure that this investment materialises by producing the Action Plan on Sustainable Finance and three regulations. Another official stressed in this respect the role of the taxonomy, which is essential to ensure investment flows to sustainable initiatives. This is about determining a clear classification of what a sustainable investment is. The Commission has identified six environmental goals, and an activity is described as sustainable if it substantially improves one of these goals without becoming a detriment to the other five. The taxonomy is a list of economic activities which are considered environmentally sustainable using the framework of Pareto optimality. However, the existence of certain activities on the taxonomy does not mean that those activities not included in it are necessarily 'brown'. Additionally, the taxonomy does not prescribe anything to financial market participants. Financial market participants would not cooperate, and the initiative would not attract private capital.

An industry representative suggested that exchange operators' function is to bridge companies and entrepreneurs needing finance and investors needing investment objects. Even in the Nordic countries, where there is excellent ESG reporting, there is an ongoing debate around information, because investors feel they do not have the information they need. The industry must understand how to build this bridge between investors and companies in terms of having proper, comparable and standardised information. Better information will enable capital to take the responsibility it needs to take in terms of focusing on investments that will be sustainable over the long-term. Capital should start to leave unsustainable uses over time.

An industry representative congratulated the work done as part of the EU Action Plan on Sustainable Finance in terms of the taxonomy, the bold requirement for ESG being an explicit fiduciary duty and for financial advisors to be compelled to ask investors about sustainability.

An industry representative stressed the importance of the international dimension to this problem. Most observers are commending the EU for being at the forefront of codifying this important space. Switzerland, for instance, follows this discussion very closely. And the Swiss authorities should not 'reinvent the wheel' by developing their own taxonomy. The exportability of EU standards to the global realm is very important.

There is a need for unification, but the rules should not be overly prescriptive, too static or stifle innovation. An official agreed with the need to extend the work on the taxonomy globally because of the importance of the global dimension to climate change.

An industry representative emphasised their institution's sustainable bond market. This market is based on the green bond initiative and the institution's own work with consultancies like « Sustainalytics ». The institution works with over 40 issuers; more than €7 billion of capital has been committed. The positive thing about this is that there is pent-up demand with big institutions in the Nordic countries. The institution is chasing issuers, municipalities and companies. The institution asks these players to come up with new ideas for green bonds, because there is so much earmarked money that wants to invest in them. Therefore, one of the challenges with the new taxonomy is to avoid destroying what has already been created.

2.2. Key building blocks to ensure there is appropriate disclosure and that risks are properly addressed globally

An industry representative expressed support for the FSB level Task Force for Climate-related Financial Disclosures (TCFD), which now has almost 600 national signatories. It is an attempt to provide some standardisation in disclosure to ensure that there is action-orientated, decision-useful and comparable data, which is what investors are asking for. Another industry representative agreed entirely with the efforts of the TCFD, noting that discussions around prudential treatment should be driven at a global level, at the level of the FSB or BCBS. On the topic of prudential treatment, senior risk-management professionals have made it clear that the industry should be very careful when incentivising one asset class, not to create the origin of the next bubble.

An official noted that the European Commission is pleased to observe that the Parliament has not placed a geographical restriction on the taxonomy. The underlying activities do not have a restricted geographical description, which is important for global investment. The Banque de France's Network for Greening the Financial System is an excellent initiative. Its focus is at the level of supervisors. The Commission has realised that the leadership of the European Union should not only be a leadership in the sense of acting first but also in terms of being able to export its initiatives elsewhere. In a recent EU-China summit there was a sentence of common agreement indicating that the EU and China would strengthen their cooperation on sustainable finance to channel private capital flows towards a more sustainable and climate-neutral economy. At the conference on 21 March, Ma Jun, the top expert on sustainable finance in China, called for an approximation between the two taxonomies. In the coming week there will be a responsible investment forum in Japan, where these issues will be discussed again. At the end of the month there is an EU-Japan summit in Brussels, where it is likely that something similar will be done. By being transparent and flexible and by using the demand side, Europe can export its taxonomy. Another official noted that the FSB is participating in the network of supervisors and Central Banks while also trying to issue a data set for pricing green bonds.

An industry representative highlighted two practical dimensions in this discussion. First, this work must be aligned to already existing economic-activity codifications. Second, this work must be implementable in IT systems. If the industry seeks to do this in a scalable way, it must be applied when processing investments at scale. In terms of the standards, the European taxonomy contains no geographic restriction for the underlying economic activity. This means that the taxonomy should take into account existing EU and non-European classification activity. There is a plethora of classifications; from a practical point of view, these activities must be integrated and aligned. A speaker queried whether a worldwide standard is practical, noting that labelling and standards might not give sufficient insight into whether an underlying product is green or not. An industry representative stressed the need to avoid the duplication of effort and multiple requirements which are very similar but not identical. An industry representative agreed, noting that climate change will not show any deference to regional boundaries. Citing the remarks made by the Chairman of the CFTC on an earlier panel, the industry representative felt it is important to regulate local markets at a local level with global standards.

2.3. Are data and disclosure enough?

The industry representative outlined how SolTech, a small Swedish company which builds solar power plants in China, issued a retail bond. This bond has secondary market trading with a market maker to retail it and it gives a return of approximately 8.75% per year. The bond was in high demand because retail investors felt this was a high return, with high risk, but they were also doing something positive by improving air quality in China. It is essential to develop practical products such as this, and then capital will flow in the right direction.

In terms of return, another industry representative described how there is often a misconception that investing for positive environmental outcomes has to receive lower yields. Unfortunately, that is something that many investors believe. However, if fossil fuels are removed from the FTSE or world indices over the last five years, this sub-market outperforms by 5.5%. Similarly, the FTSE Environmental Opportunities All-Share outperformed the FTSE Global All Cap by 14.3% over the same period. The industry has the data points which demonstrate that low-carbon investment is not only helping the planet but also driving yield. Work conducted by asset managers indicates that green indices can produce yields that are very comparable to other indices.

An official noted that disclosure has been accepted not only in the Council and the Parliament but also by professionals. There is data and evidence which suggests that bringing sustainability concerns to the attention of investors makes them very likely to take up these investments.

Asked whether this was enough, the first official stressed that there are solid interventions in certain areas of finance, such as products. Cars are a good example of this. Diesel cars will be prohibited in cities within the next five years. In other places, there are incentives to buy green cars or to install solar panels. If a consumer asks to finance a sustainable product, it is much more likely that they will be accepted for financing rather than for a car which will not be able to drive in any European capitals within three years.

Another official added that there would need to be further development of technology. The industry must determine how it will finance the transition and the research associated with this development of new technology.

3. The future of sustainable-finance policy

3.1. Incentivising 'green' or penalising 'brown'

An industry representative felt that the industry is changing quickly on the investor side, noting how superior returns could be achieved by excluding coal-produced electricity from markets. In Sweden, pension companies are trying to determine how they should allocate their capital to deliver pensions in 30 years time. These companies are seeking to move from exclusion-investing to impact-investing. This is where the next 'big wave' will be. An industry representative explained how their institution has been actively investing in the microfinance refinancing space and conducting impact investing for 15 years, agreeing that good returns could be made here.

Another industry representative emphasised that every investment has an impact, but it is for investors to choose whether their investments have a positive environmental impact or not. That might not be how the market speaks, but it demonstrates the necessary shift in mentality. The industry representative described how there is positive data on how global asset managers view ESG factors. Bloomberg and Morgan Stanley recently surveyed 300 respondents from US asset managers with over 50 millions of client assets. The most interesting statistic from this survey is that nine out of 10 are intending to devote more resources to sustainable investing over the next two years across in-house training, the redeployment of employees and making specialist hires. No matter how good the data is, without expertise and leadership it is only another set of numbers. If this is going to have the impact the world needs, the industry needs far more people who are climate-literate and who understand exactly how to interpret this data.

An official explained how in economics there is a well-known question regarding the trade-off between transparency and incentives. Europe must ask itself whether transparency is enough. At some point, perhaps the industry will view it as insufficient to have transparency and decide that it is necessary to introduce incentives. If incentives are necessary, there will need to be both positive and negative incentives. An industry representative agreed on the need for both 'sticks' and 'carrots'. The 'carrot' of the taxonomy is a positive place to start, but the world will also need some disincentives for the 'brown' part of the market.

Another industry representative emphasised that the issue facing the world is one of time. The market is moving in the right direction, but, as economists are pointing out, carbon is the greatest market failure in history, and the market is not moving fast enough. A third industry representative considered that there is an important balance to be struck in relation to the prudential treatment of sustainable investments. There must be a balance between subsidising green versus penalising brown. It is important to incentivise investment, but risk sensitivity must also be maintained.

An official stressed the importance of discussing the 'impatience' that had been mentioned, highlighting the legitimacy of this question. Certainly, Europe is creating a taxonomy and green indices, and people will invest in those indices. However, there are other things that need to be done at the global level. It is important to have a global accord, a direction, targets and financial instruments which fulfil certain criteria. Investors must be able to do some good by purchasing certain kinds of investments, however, some jurisdictions are doing things more directly. For example, some developing countries are subject to heavy levels of pollution, and these countries are directing credit towards removing pollution. They favour prudential rules which have a lower capital requirement for these specific loans. Various jurisdictions such as Brazil use the satellite mapping of rural areas to determine whether certain properties are respecting the minimum reserve requirements in terms of land not used for cultivation and then associating loan-granting to the properties meeting this criterion. An industry representative expressed caution in relation to the prudential argument. Whilst the taxonomy is an extremely positive first step, it cannot be viewed as a panacea. The taxonomy will provide the data that enables the industry to identify the asset classes where risk and return are not currently being appropriately viewed.

An official suggested that Europe is trying to act in a strong and consistent manner. Europe is seeking to exploit the demand side, which at present is very strong. If this is successful, this will be a fantastic achievement. If it is not successful, there will have to be mandatory instruments and requirements. Another official agreed, emphasising the need to be cautious. The political economic equilibrium of any country is a delicate combination of taxes, debt and productivity effort. The industry must ensure the transition is effective and avoids a negative reaction, which would undermine the whole drive towards a low-carbon economy.

3.2. The pricing of the systemic risk posed by carbon needs to be improved

An official noted that the carbon bubble previously mentioned is in fact a 'reverse bubble', because the pricing of the systemic risks posed by carbon needs to be improved. This is not necessarily taken into account completely by current instruments. Due to the difference between the social cost and the private cost, the BIS seeks to improve the disclosure concerning these assets, the transparency around the concentration of these risks, and the perception of long-term threats to financial stability that these risks can entail.

Market instruments are beginning to price these incentives positively. The markets are realising that it is important to consider the reputation and quality of governance in some of these companies that care about climate-change risk and acknowledge the fact that many green technologies are improving.

3.3. Deprived countries will require help in the transition to sustainable finance

An official considered it important to address the costs of financing the transition, particularly for developing countries. Recent discussions have indicated that the world may experience an environment of low interest rates for an extended period of time. The balance sheets of public institutions could be used to finance this transition at a global or regional level. There are public-sector financial institutions that could fulfil this role of financing the transition, including in Africa and Asia. An official suggested that the world must help finance this transition in poorer countries which cannot finance it. All of these initiatives must happen at the same time.

1. "Breaking the tragedy of the horizon" speech by Mark Carney, Governor of the Bank of England.