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PROSPECTS OF GLOBAL AND EU ESG STANDARDS CONVERGING

1. ESG standards: what is at stake

1.1 Encouraged by the actual correlation between financial and non-financial performance, investors play a key role in leading companies to addressing essential challenges of current generations

An official commented that a single shared, standardised language is needed for corporate information. The biggest challenge of this generation, in addition to COVID-19, is climate change and the related social inequalities and human rights violations. To tackle this, companies are required to be sustainable to make it easier for them to receive funding.

An industry representative explained that the sustainable finance package originally intended that disclosure would change the behaviour of the underlying companies that need the capital flows, either from investors or the banking and insurance vectors.

Another industry representative stated that active asset managers use data that corporates disclose to help their transition. Different frameworks can make reporting burdensome for issuers. There is increased data evidence of a correlation between financial and non-financial performance. Current investment decisions are therefore also based on non-financial data, already in current decision making even ahead of respective regulatory obligations coming into force.

An industry representative reported that the top three reasons given in the Zeronomics survey for organisations not fully supporting the aims of the Paris Agreement were a lack of finance, the need for regulatory certainty and the lack of clear standards on the net zero definition and targets. Standard Chartered Bank is supportive of the International Platform on Sustainable Finance (IPSF) and grateful for the work of the International Organization of Securities Commissions (IOSCO).

1.2 Companies' disclosures are essential to empower investors and enable a sustainability dynamic

An official noted that policymakers and regulators aim to avoid unintended side effects on the efficient functioning of the financial markets. Transparency and standardisation are at the centre of international debate.

An industry representative commented that investor demand for ESG funds is rising. The supply from asset managers is increasing, with the sustainable finance disclosure regulation (SFDR) article 8 and 9 products coming to the market. The asset management industry is starting to integrate more ESG factors into the investment process. The foundation and nucleus of all this is corporate disclosures.

1.3 There is an opportunity to leverage the increasing global political alignment to deliver transparent, comparable, and standardised information

An official commented that there is an urgent need for public and private standard setters on non financial information to deliver consistency and compatibility. There is still no single definition of sustainability.

2. Policymakers' efforts at EU and global levels

2.1 The EU is now focusing on making the Non Financial Reporting Directive consistent with the various recent ESG initiatives

A policymaker indicated that the non financial reporting directive (NFRD) will be reviewed and updated to ensure it is consistent with other EU legislative interventions.

2.2 This review is part of the Commission's agenda to foster sustainability transition, which also represents a recovery opportunity for the EU in the Covid-19 crisis context

A policymaker confirmed that sustainable finance is high on the Commission's agenda. Sustainable finance is a part of the Commission's plan for a quick, efficient, and sustained recovery.

2.3 NFRD: giving the investors the detailed and precise information that they need and addressing information consistency and comparability issues at the European level

A policymaker explained that the NFRD review aims to widen the scope of the NFRD. Obligations stemming from the directive will be made more concrete, detailed and specific. The directive covers sustainability in the ESG interpretation, including social issues, human rights, and governance. Standards are different everywhere. Information is not comparable and therefore not useful for investors. Some companies do not report at all. European standards for reporting on non-financial issues will build on and coordinate with standards that already exist.

2.4 The focus of policymakers should also be on making the information needed assurable

An official commented that the public sector is needed because, no matter how effective the work of market participants, consistency and comparability in reporting is necessary. Public sector intervention ensures that information is assurable.

3. Although human capital is an actual priority in the EU, related value-creation metrics and information require steep improvements

An industry representative noted that there is agreement among most speakers on the need for comparability, global standards and ensuring any actions are useful for end investors and companies. Focus should be on human capital and practical suggestions. The NFRD

was one of the first reporting standards that included human capital and a need for diversity data. In analysis carried out by their Group, human capital is of equal importance to other ESG considerations (as climate change), but there is very little reporting on it.

An industry representative advised that frameworks should align with the sustainable development goals (SDGs). Covid has highlighted the importance of inequality. Without human capital, no economy or company can remain competitive. International collaboration could begin around an issue as simple as human capital. The Securities and Exchange Commission (SEC) has recently noted the importance of human capital. Companies are requesting simple, clear, understandable metrics. Europe is doing well on diversity of workforce but lagging on diversity of senior management. Better data on global breakdown of ethnic diversity and how companies invest in the workforce is needed. Human capital would be a great platform to ensure the S is included in ESG and to get strong international collaboration.

4. Emerging markets should be further considered to progress climate change issues

An industry representative noted that the biggest and fastest source of emissions now, and the area that has suffered almost twice as much damage already from climate change, is the emerging markets. It is also where there is the biggest opportunity to leapfrog to low-carbon business models. There is a lack of capital going into tackling sustainability in these areas. Feedback has been received from investors and other actors around the lack of common standards. Standards should encourage capital to move to where it can have a huge impact.

5. The journey toward convergence starts with meaningful, monitored and verifiable data

An industry representative commented that basic information can be built on. The largest companies can make the biggest difference in the shortest time, so the initial focus should be on reporting by large companies. The required quality and consistency of data is not present in the financial services sector now. When data is in the audited accounts, it is possible to have a reasonable definition of what is assured and what has an opinion against it. When it is presented as a non-financial disclosure, it should not be a marketing document.

6. A centrally developed set of standards might lack agility and fail to deliver an optimal flow of capital

6.1 Frameworks are often static and backward looking, which leads to lost development opportunities and industry-specific transition pathways being ignored

An official stated that well-functioning capital markets enable capital to flow to the people who can use it best. Pre-planned capital markets operating according to a centrally developed set of standards cannot do this, because they channel money to wherever the people who wrote those standards thought would be the source of the solutions. Issuers and investors want a common framework, but the price of that framework will be high in terms of lost opportunities.

6.2 Information on the transition pathway and comparisons of the impact of investments should improve capital allocation globally

An industry representative emphasised the importance of a definition of transition. Reporting and definitional frameworks in the green markets are often static and backward looking. The technologies that will drive the future are unknown. Several industry-wide transition pathways across eight of the most carbon intensive industries will be published later in the current year. The banking and finance sector tends to celebrate volume over almost everything else, often at the expense of impact. Where and what is just as important as how much.

An official commented that the aim is the creation of a market that delivers the outcomes that public policy is seeking to achieve.

7. A framework for markets that can operate across borders is needed. However, balancing regional priorities will be challenging

7.1 A framework for markets that can operate across borders is needed

An official reported that the UK was the first country to announce its intention to make TCFD disclosures fully mandatory across the economy by 2025. The EU's ambition on sustainability reporting has been world leading. The NFRD will significantly strengthen sustainability reporting. International activity is needed because no one jurisdiction can fund a shift on its own. There are real-world geographical differences in how objectives will be achieved. A set of baseline international sustainability standards is needed, building from the TCFD architecture. In addition, individual jurisdictions have to develop their own disclosure requirements.

7.2 Existing regional or national ESG preferences and philosophies that are reflected in regulations raise competition and comparability concerns: a global solution is necessary

An industry representative commented that regulations inform the investors' definition of ESG. On the supply side, capital flows are international, and corporates operate with global supply chains. Diverging ESG rules across the globe make comparability difficult. There is also the potential challenge of corporates exploiting regulatory arbitrage across global supply chains. The NFRD is wider in scope than the TCFD and has a dual materiality approach, meaning that the data is not comparable.

An official commented that ESG is an emerging markets issue. A report published by IOSCO through the Sustainable Finance Network identified the multiplicity of sustainability frameworks and standards, greenwashing and challenges to investor protection as problems. There is an urgent need to improve the consistency, comparability, reliability and auditability of sustainability reporting.

7.3 Looking beyond what is material to a particular company, through a double materiality lens, is very foreign to the US disclosure regime

An official explained that the US materiality framework encompasses much of the sustainability factors under

discussion only when they are material to the long-term financial value of the company. The US disclosure regime is a materiality based, principles-based regime and accommodates many different companies and industries.

7.4 Achieving global consistency with respect to ESG reporting will be as difficult as it is for financial accounting

An official stated that objective financial accounting standards are a key part of the disclosure regime. These change as companies and technology change. Achieving global consistency with respect to financial accounting is difficult and doing the same for ESG will be hard. Focus should instead be on ensuring quality of disclosure.

8. Policy making: ways forward

8.1 Against a plethora of initiatives, many propose the IFRS to be instrumental in fostering consistency and convergence

An official stated that baseline standards that can be applied internationally are needed. The International Financial Reporting Standards (IFRS) Foundation is the custodian of international financial reporting standards. The UK Treasury is very supportive of the International Regulatory Strategy Group's (IRSG) work. Political support and technical input from jurisdictions will be necessary to support the work of the IFRS.

An official stated that global standards need to be strong on governance. IOSCO supports establishing the sustainability standards board under the IFRS Foundation, given the governance there. IOSCO will endorse those standards once they are reviewed and found fit for purpose.

8.2 The challenge will be to leverage the work already done by multiple initiatives and to avoid competing on policy making

An official noted that much work is being done by the voluntary standard setters and the alliance of standard setters, building on the TCFD recommendations. In that context, technical work is already being done by the IFRS Foundation and IOSCO. The approach considers climate first with other issues not too far behind. Continued engagement and governance through the monitoring board is needed, also the recognising of the role of the European Commission.

An official commented that the EU has a longstanding commitment to promoting and developing effective international standards and is in a unique position to integrate common baseline international reporting standards and to be at the vanguard of leadership on the issue globally.

An industry representative stated that the solution should be collaborative, not competitive. A minimum set of standards should include clear, globally comparable definitions.

An industry representative commented that the current situation is challenging, and small steps should be taken initially. Collaboration is necessary for global markets to function well.

An official noted that there is value in homogeneity, but there are also costs to homogeneity, such as undermining the existing framework.

8.3 Achieving flexibility will be key

An official commented that the IFRS's approach will be delivered through building blocks, enabling individual jurisdictions and regions to supplement those baselines.

An official agreed that the building blocks approach is important. More is probably made of double materiality and single materiality than necessary. A European Financial Reporting Advisory Group (EFRAG) report discussed dynamic materiality and how the superset of sustainability topics would eventually become part of enterprise value creation.

An industry representative commented that dynamic materiality can help bridge the gap between pure financial materiality and double materiality. What is material to investors is changing.

An industry representative commented that the high bar already present for financial services reporting should be used to ensure that data provided is relevant. The more detailed and less flexible the rules are, the less likely global collaboration is.

8.4 The EU will go ahead favouring coordination and consistency with different standards and initiatives

A policymaker stated that global markets require global responses. European standards will build on the work that has been done already, aiming for the highest possible level of coordination, consistency, quality and even complementarity with the different standards. Slight adjustments for different markets and business models might be needed. Global coordination and the work that has been done by IOSCO, the IFRS Foundation, the Financial Stability Board (FSB) and G20 is important.

EU SUSTAINABLE FINANCE TAXONOMY IMPLEMENTATION

1. The EU sustainable finance policy agenda

1.1 Sustainable Finance at the forefront of the policy agenda

A policy decision maker remarked that the delegated act regarding the taxonomy is expected to appear within weeks and proposals on the Non-Financial Reporting Directive are also expected.

A policymaker stated that back in 2018, when the first action plan on sustainable finance was submitted, the subject was somewhat exotic and marginal. Three years later, it is at the centre of the debate and at the heart of the European and global financial system reforms.

1.2 The EU sustainable taxonomy is a bedrock of the EU sustainable finance policy

A policymaker noted that the EU taxonomy is at the heart of the proposed reforms. It is a classification system for environmentally sustainable economic activities. The desire is to create a trustworthy tool that helps to translate environmental objectives into clear criteria for investment purposes, and to define which activities are in line with the 2050 net neutrality objective. Sustainable activities are explained, so investors can be guided if they want to invest green and sustainably. The other goal of the taxonomy is to give guidance regarding the journey to sustainable economies. The policymaker (Marcel Haag) stated that while firms and the financial sector must transition, they cannot do so all at once. The move is from less sustainable to more sustainable.

1.3 Complementary legislative pieces and the renewing of the EU sustainable finance strategy

A policymaker explained that the intention is to submit the (first) delegated act on the Taxonomy later in April. There is also work on the data challenges. A review of the Non-Financial Reporting Directive will be submitted before the summer. Another delegated act on the taxonomy-related information companies will have to publish will be submitted. How to consolidate and further develop the Sustainable Finance Framework will also be considered. The intention is for a renewed sustainable finance strategy to be submitted before the summer.

A policymaker stated that the desire is to converge towards the taxonomy. The European Parliament and the Commission have a very important job, and a great deal of power in defining where a large amount of investment is going to go in the next few years. They must continue to be as rigorous as they have been because that will become the standard globally.

1.4 Making consistent green bond principles with the EU taxonomy is also necessary to further foster sustainable investment

A policymaker stated that the Commission is joining the ICMA Green Bond Principles, but given the programme is structural the taxonomy is something to converge with. The sooner the delegated acts are published and the clearer and more user friendly the taxonomy is, the easier it will be for sovereign issuers and sub-sovereign issuers to engage in this investment.

1.5 Investor protection is essential for sustainable finance to succeed

A regulator emphasised that the tool must be powerful enough to protect investors from greenwashing. Were there to be an accident involving inappropriate use of green labels, trust may disappear very rapidly.

1.6 EU public institutions are on track

A regulator confirmed that there are real challenges. At the European level, thanks to the European Parliament, the Commission and the EU Council of Ministers, agreements at level one and to some extent level two, have been reached for a rather comprehensive framework, which is very ambitious. It is the most comprehensive framework existing worldwide, supported by all co-legislators on a consensus basis.

1.7 Challenges faced by the definition of the regulation

A regulator warned that however the devil is in the detail. Regarding implementation challenges, the framework at the European level is very impressive. At the legislative level two, the choices made at level one, must be implemented. Each member state needs to be on board. In his jurisdiction, appropriate external communication was launched. Sustainable finance at the European level there is a step-by-step approach and attention also must be paid to avoiding a one-size-fits-all approach.

1.8 Pragmatism is required to combine the EU and global sustainable finance agendas

A regulator stated that, on the link with the worldwide agenda, when the discussion at the International Organization of Securities Commissions (IOSCO) level started regarding non-financial information standards, it was asked who needed to be in the first line and the answer was the International Financial Reporting Standards Foundation. They have experience with due process as well as technical legitimacy and can address the agenda.

A very ambitious but prudent agenda is being set up by the Commission. There will not be competition between Europe and the global agenda. However, the speed may not be the same.

In addition, EU political decision makers are paying attention to the social aspect and human rights dimension. The starting point at the worldwide level is the classical aspect relating to sustainable finance. At the end of March 2021, the Financial Stability Board (FSB) stressed that it welcomed the steps being taken by the trustees of the International Financial Reporting Standards (IFRS) Foundation, supported by IOSCO, to accelerate convergence in sustainability reporting. It must be understood who is best placed to come with additional regulation. For some aspects it will be the Europeans. For some extensions it could be at national

level. For other aspects, finding consensus will require a opting for a building block approach. Europe cannot achieve the green transition alone.

2. Key success factors of the EU taxonomy

2.1 To be conducive to transition the taxonomy must evolve continuously

An industry representative stated that the obvious goal is net zero, and protecting the environment, the climate, and the planet. Europe is leading now and will continue to lead with regard to this challenge. However, certification of the taxonomy must be based on transition. Companies that are at present brown but have every intention to become green need to get exposure to capital to fund that transition. If this transition is not managed properly and effectively, incumbent companies that have every intention of being part of the solution could be stifled, which would be cataclysmic. Europe can also export the technologies, the skills, and the services.

A policymaker stated that the taxonomy already provides for transitional activities. The feedback on the delegated act indicated that more clarity is necessary, along with more sophistication when it comes to transitional activities.

However, more can be done to support companies on this transition, and the expert platform on sustainable finance has been asked to help develop the transition framework further.

An industry representative noted that the taxonomy gives the targets but it is not a tool for transition. He explained that they have developed a an internal tool to assess the transition of clients through a kind of colour or rating on the way the company is organising and progressing on its transition to the net zero target. However, this tool is not taxonomy compatible as it is a tool while the taxonomy gives the landing zone.

2.2 Implementing the taxonomy is a huge challenge which requires gathering beforehand some key success factors which will prevent any taxonomy-washing

An industry representative suggested that Europe should leverage the work on the taxonomy and come to the implementation phase as soon as possible, while maintaining the consistency of the taxonomy, including its science-based foundation.

There are important caveats for starting the implementation. There is the data issue, as was mentioned. To apply the taxonomy first, at the company level, a granular analysis of each activity is needed, in a context where the data to perform this analysis is hardly available. Thus, the conditions for a safe implementation must be thought about. This includes starting quickly to benefit from the learning curve as the implementation of the taxonomy will take time. In parallel it is necessary to build what is missing in terms of reporting tools, guidelines, completing the taxonomy, etc. There should be a transition period where companies can test, so when eventually official numbers are disclosed, they are actually reliable. Otherwise, publishing unreliable numbers could lead to what could be called taxonomy washing.

3. Sustainability data stakes, challenges, and success factors

3.1 Transparency is a precondition to accessing funding, cheaper funding

An industry representative noted that what works everywhere in the world is data transparency, to the extent good and granular data can be used to provide comparability. The interest an entity has can completely change the dynamic of the conversation related to sustainable finance.

An industry representative stated that there is the underlying issue that for the issuer, equity or debt, there is a prize for being on the right side versus a stick for being on the wrong side of the taxonomy, namely access to funding and to cheaper funding. That provides a reason to disclose more, better, and clearer data but also an incentive to manipulate data for the best numbers possible. It is therefore important for investors in these businesses to have some level of standardisation and accountability on the information being provided. If Europe does not get this disclosure part right with auditable, standardised data at corporate issuer level, then the risk is that, as this topic flows out of Europe, control will be lost over what is material.

3.2 Aligning bank reporting with the EU taxonomy is prevented by SMEs not reporting such information

An industry representative favoured taking a progressive approach, because there is a 'big wall' to contend with: the green asset ratio.[1] Currently it is only a 'wall' because the data is not there to assess the size of the green part of the outstanding of the bank. According to the EBA, the data from SMEs should be included in the reporting of the bank, but SMEs have no regulatory obligation to publish the information regarding the alignment of their activities with the taxonomy.

The taxonomy is not a tool for supporting, encouraging, and recognising the transition to a low carbon economy. The risk is not being seen as the pioneer of sustainable finance in Europe, and instead being the bad student of sustainable finance in the world due to not being able to issue the right level of green outstanding. The way the taxonomy is designed is somewhat opposed to how companies are financed. The taxonomy has an activity approach, while banks assess their counterparties by considering the company rather than the various activities it encompasses.

3.3 Technical and regulatory requisites for producing much-needed data

An industry representative stated that a key success factor is creating an EU data repository for SMEs. On the other side is leveraging technology much more. The problem lacks borders, so there is a need for a common perspective. Artificial intelligence and machine learning can do much to support the needs of the financial

1.The Green Asset Ratio (GAR) shows the proportion of assets that are environmentally sustainable (Green Asset) used to identify whether banks are financing sustainable activities. The GAR is based on the EU Sustainable Finance Taxonomy and is "Paris agreement" aligned.

industry in meeting the objectives. This can make for a much more global approach. Without a global approach the level of financing will be reduced. If the level of financing for the transition is reduced it will never be possible to get to where is needed.

An industry representative remarked that both data accessibility and the numeric format are important, and hence probably a European single access point (ESAP) also. There are many data requirements. The role of the non-financial reporting standard should be to define this data or make precise the data already required.

4. The ever-growing demand of investors regarding ESG information globally

4.1 Investors and asset managers have increasing expectations regarding EGS information although reliability and comparability of data remains challenging

An industry representative noted that their firm has been able to go out to financial institutions, particularly asset owners and asset managers. On a global basis, 75% really want to use environmental, social and governance (ESG) criteria, integrating these factors in their investment decisions. This is very positive compared to the current number. However, regarding securities investments, the comparability, and reliability of ESG data are real issues to be addressed.

A regulator stated that one challenge is how to go from many interesting initiatives and self-regulation to regulation. There are many labels in all jurisdictions. Usually, they are very successful, but they are very fragmented. EU investors should not have the impression that the labels on financial products, which are usually self-regulated, are not interesting or that there is no capacity to believe in the sustainable aspect of them.

It must be very clearly stated, especially from the European side, that the taxonomy, if developed in isolation, could lead to greater fragmentation of practices, and could even inhibit the growth of global sustainable finance. What is needed is one standard that considers some specificities at a regional level.

4.2 The priority focus may differ across regions in the world, which raises consistency issues

An industry representative stated that Europe is much more advanced than any other region on ESG, particularly on the climate agenda. In the US there would be more discussions about E and S. In Asia it is probably more on the Social and Corporate Governance aspects.

A consistent theme is the need to make things simple. Europe can be at the forefront of any conversation on this topic because of the splendid work that has been done so far. Maintaining that science-based approach and the simplification for looking at the taxonomy would probably be best for maximising the results in terms of international co-ordination.

An industry representative stated that Europe's leadership in net zero targeting is exciting. Key to European success is that European investors want financial security, but also with a strong element of sustainability. Europe has created a regulatory framework and is putting the taxonomy as the basis of certification. An industry representative (Hideaki Takase) appreciated that much progress has been made by the EU, which is a frontrunner in the discussion. To achieve the goal the global economy must work together.

The new prime minister of Japan declared that the country aims to achieve net zero by 2050. The banking industry and companies in Japan need to work together to contribute to that target. Multiple taxonomy frameworks complicate bank operations across multiple jurisdictions. Investment in the green area is important, but more important is the necessity of the transition from high-emitting sectors to more sustainable and energy efficient solutions.

The question is how to leverage the EU taxonomy, adding the global context and creating a consistent framework. A good example of global co-ordination is the International Platform on Sustainable Finance (IPSF). Many companies from the private sector joined this body to discuss how to coordinate. Due to new technologies and ongoing business, the taxonomy needs to be dynamic and flexible, not a static framework.

5. Challenges posed by the global convergence of sustainable finance standards

5.1 The current European leadership should benefit from the involvement of the EU in several international fora

A policymaker stated that Europe has a chance to remain a leader in sustainable finance. The priority is to do what it has been committed to and to do it right. There is engagement internationally in several fora. The G20 has started a working group on sustainable finance that will be led by the US and China. There is the G7, COP26 and so forth. There is no contradiction between having an ambitious European agenda and the international conversation. Efforts must be made to align internationally and then allow for regions and nations to go beyond the internationally agreed standards.

5.2 An effective transition toward economic sustainability should not be watered down by seeking convergence at the global level

An industry representative stated that as the leader in this area the EU should not leave everyone behind. This is a global standard and a very important global challenge. The hope is that good global coordination will accelerate.

However, a policymaker believed that the world will converge towards where it sees more rigour, and the taxonomy has the potential to provide that. 'Rigour' is not something static, but a mutually exclusive, collectively exhaustive list of differently classified activities with a dynamic sense. This is very similar to what is happening with data protection. The regulatory power of Europe can attract others because it is seen as more rigorous. Ambition should not be lost. It can be designed to be more user friendly, and with non-financial disclosures it can be made possible for small and medium-sized enterprises (SME) to provide data, but it should not be less rigorous for the sake of universality.

CLIMATE RISK IMPLICATIONS FOR THE EU FINANCIAL SECTOR

1. Addressing the climate-related risk

1.1 Developing the new risk managements metrics and practices needed to assess climate related risk will take time

A regulator commented that there is a broad agreement on two things in climate risk: firstly, it has far-reaching consequences, much will depend in the long term on what we do in the short-term, and it affects very directly financial firms. While it does not originate with financial firms, they should not underestimate their impact on what they do for them and for society at large. Secondly, the traditional risk metrics are not sufficient. Data gaps are huge. Without better disclosure of the "known knowns" and "known unknowns" using a common language, little can be said about risks and transition. And the more we wait the more costly.

A Central Bank official stated that there are many challenges. There is huge uncertainty related to the size and timing of these risks stemming from climate change, meaning that the historical data is of very little use. The work has barely scratched the surface of really understanding how climate risks drive the uncertainty of traditional financial institutions. Physical risk and transition risk tend to be spoken of in one sentence, whereas there is a huge difference in how they affect financial institutions and what data is needed to address these risks. It is very hard to estimate when there will be tipping points in consumer behaviour, political behaviour or technological breakthroughs. Europe needs to work on a forward looking strategy.

An official noted that while climate risk drivers are relatively new in the risk landscape, they can be adequately captured by traditional financial risk categories. Since for a bank, climate ultimately translates into credit, market, liquidity risk, or operational risk. Considerable work remains to be done to translate this theory into practice. Climate is an extremely long-dated risk and that makes measurement challenging. A globally agreed taxonomy is necessary and more data is needed to make existing regulatory and supervisory frameworks work well.

An industry representative commented that existing metrics need to be used, because at the end of the day it is financial risk. There are also challenges specific to climate change, such as the time horizon. With climate, there is much more emphasis on understanding where business is being done and the location of the underlying asset for an investment or a loan. There is a very long way to go when it comes to physical risk. Working with historical data only gives a distorted image of what the future holds, because the physical impacts of climate change are going to be different and beyond anything that was expected in the past. In Europe there are less frequent extreme weather events, but the problem is that the models are not set up to capture that kind of existential risk. The models are better suited to capturing incremental changes, but the type of potential dramatic changes that are in the system are not necessarily easy to represent in the form and the type of models that are currently used.

An industry representative stated that there needs to be an acknowledgement that society is at the beginning of the journey in terms of modelling and understanding such risks. The same is true when looking at net zero carbon, not just physical risk. The technological changes that are required for moving away from fossil fuels entirely, are a little bit beyond what the models can currently capture.

1.2 Investors as well as insurance companies share the same priorities; but commonly agreed concepts and definitions are needed to access adequate and reliable information

An industry representative commented that this is as much an opportunity as a risk. It depends on what type of insurer someone is and whether they are a life insurer or general insurer, looking at the two sides of the balance sheet. It is important to really understand the transition risks and what is going on in the real economy. The disclosure and getting hold of this data is very important, but the problem is the lack of standards. It is difficult to tell who is greenwashing and who is really acting. Recent reports from the CA 100+ and the Transition Pathway Initiative show that fewer than 10% of the total companies are getting anything right.

An industry representative stated that there are plenty of initiatives in the private and public sectors, but no commonly agreed definitions, concepts, or expectations and this makes it hard for firms and authorities to perform an in depth assessment of the current situation and draw meaningful comparisons. Certain players will get attached to what they have been doing so far, while others may prefer to wait and see. Europe is far from having a very precise understanding of environmental, social and governance (ESG) physical and transitional risks from a whole-firm perspective, let alone from a system perspective. This is mainly because the information is difficult to obtain. If Europe was to get there it would also be necessary to complement that with a more forward looking approach in terms of transition risks.

A Central Bank official noted that national banks tend to be frontrunners in the fight against climate change, but the road ahead is challenging. The approach focuses on three main priorities: data and disclosures; risk management; and governance and strategy. The previous place had been one of no taxonomies or regulatory approach, but Europe is now starting to have a common language. It is time to stabilise the referential that everyone uses, so everyone can use the same language and use comparable concepts. It is not just for banks to steer transition for the broader economy.

An official (agreed that something is needed that is globally harmonised. Currently the contents of the information vary, depending on where the reader sits and what system they are under. Data is needed.

1.3 Data credibility requires addressing an unprecedented complexity

An official agreed regarding "the known unknowns". There are a number of data gaps and the market is starting to meet them. If companies can help banks adjust existing risk management tools and measurement methodologies by incorporating the knowledge that organisations bring, it will go a long way to bringing the kind of data that is needed. There is some talk about whether the risk weights need to be changed, to reflect climate risk. Banks are now making some of those decisions on their own.

An official noted that 10 or 15 years ago it was possible to see insurance industry companies focusing on their internal ecological footprint, as if they were trying to show the world that they were responsible. However, in the last three or five years there has been an explosion in ambition. Modelling risks are seen, the investment side is seen, and a number of tools are seen to measure and represent the risks. It is very hard to predict the future. One way of calculating the risk, as well as the transition risk, is working with scenario analysis.

An official wondered if companies have recently moved on that. When looking at what climate means from a net zero, forward-looking perspective, it is a completely different approach and a very demanding one.

An industry representative agreed that it becomes incredibly complex. Their organisation has committed to provide hundreds of billions of dollars in sustainable financing for the next 10 years. The devil is in the detail of how to count against those hundreds of billions of dollars. Biodiversity is potentially a dimension that is even more complex than climate, but the whole point is to help the clients transition. It is important that there are no other players that are less scrupulous and end up financing the same businesses that banks are exiting from and reaping the profit.

With respect to ESG data, the drive toward standardisation should not end in excessive simplicity. It is incredibly complex, and the method is difficult. Standards are needed regarding data, but they need to reflect the complexity in a scientific way.

1.4 Structuring an appropriate transition path for economies requires further collaboration between financial institutions, corporates, and public authorities

An industry representative stated that climate risk is the defining risk management challenge and a strategic opportunity for any financial institution that is operating within the EU. Everything should focus on the endgame about how to get emissions down to "Net Zero" in order to reach a 1.5-degree world in 2050. Financial institutions have a really important role in achieving that. The first step is to start the journey. Companies need to examine the conditions for an effective climate risk management, looking at clients, communities, culture, calculations, controls, conduct, contracts, and communication.

An industry representative noted that one aspect that has not been deeply touched upon is client engagement. The industry representative's company has developed a client energy transition framework, and started with three sectors: oil and gas, coal mining, and utilities power generation. It will gradually phase out lending to clients unaware of ESG, comprising approximately 10% of exposures. It is not just a banking job; it is a collaboration with the client, but it is also a collaboration with governments and policies. Sometimes clients are faced with a conundrum, which is whether to continue to do traditional business, which is very profitable, or invest in a less profitable and less certain type of renewable business that is still in start up mode. Government policy should also keep pace with the direction of travel.

An industry representative stated that their company works with banks, investors, and insurance organisations that are looking to improve their risk management processes and prepare for these incoming regulations. There are significant variations in the market in terms of the depth of reporting, analysis, and awareness. Those variations can even be seen between regions. There are differences between small and large institutions; that is very important because smaller institutions are certainly not as far along in the process.

1.5 Although developing views in the very long term is a challenge, climate-related risk is also an opportunity for the insurance sector to leverages existing knowhow

An official agreed with much of what has been said, as their expertise is insurance and pensions. While the investment side is interesting, what is special for insurance is that climate risks and sustainability are not just the concept of an operational risk or of transforming into liquidity. They are also areas for opportunity. The dialogue is a developing area, but the insurance industry was way ahead of the regulators to begin with.

An industry representative explained that on the underwriting side it is about how to link climate risks with the financial risks, and whether they are market risk, credit risk or operational risk. In insurance there are other risks in pricing and reserving risks, and natural catastrophe risk modelling, which is very well understood. The challenge is how to apply those metrics to transition risks and physical risks. That is very complex in the detail, with simulations of climate over very long periods into the future. The industry representative's organisation has already started to offer its clients services about that, helping them understand the impact of physical changes in the climate that might impact their physical assets such as their factories and supply chains. The aim is to help people understand the transition and communicate that in a standardised way to investors.

2. ESG and climate related challenges

2.1 Supervisors at national, regional, and global levels are addressing ESG challenges, which require however strong political commitment and support

A regulator noted that the European Banking Authority (EBA) has been mandated by the Commission to take a deep look at three things: ESG risk management and

supervision in the EU; realistic methodologies to assess the alignment of banks and investment firms with the EU taxonomy; and the key features of a harmonised disclosure framework for these firms. In May it will release the conclusions of a pilot exercise carried out with 28 banks from 10 EU countries which will shed light on what can currently be said of the carbon footprint of some of their non-SME portfolios using different approaches.

An official explained that the Basel Committee's public version of its workplan was scheduled to be released that week. The Committee's work programme over the coming years has placed climate risk high on the list. A dedicated taskforce on climate risk was set up in 2019, co-chaired by Frank Elderson, from the ECB and Kevin Stiroh, who leads the Federal Reserve supervisory work related to climate change. Two analytical reports have been produced, which explore how climate risk drivers arise and impact both banks and the banking system at large, and the current practices that banks and supervisors use to measure climate-related risks.

An industry representative observed that there is a great deal of piloting going on in the market, especially from larger institutions. It is important to have the right balance between the push to raise the bar that is coming from all the regulatory agencies and governments and leaving flexibility. That flexibility is what enables everyone to understand how far they can go.

An industry representative noted that to be successful in this enterprise it cannot just be the financial services sector that applies the pressure; it also has to be government, with democratic acceptance of the decisions that governments make. Companies have to work closely with people to help them make the transition and to understand what the different pathways are.

An industry representative stated that when thinking about the 'S' of ESG there are significant transition risks that are faced, even in Europe. One example is the coal sector and the massive challenge that will place on the economies of Poland, the Czech Republic, and Germany as they transition out of a coal based economy. Insurance companies provide a great deal of support through helping manage employee risk, but also with managing the pension risk through the life insurance sector. Companies must work in concert with covenants to work on the societal risks, the transition risks and the adaptation.

2.2 Other ESG areas such as loss of biodiversity, deforestation and water scarcity show many similarities in terms of stakes and risk to climate-related ones

A Central Bank official commented that climate was the first issue on their agenda, but what goes for climate will also probably go for other environmental developments. A report issued last year signalled the loss of biodiversity. There was a vast decline in ecosystem services, and therefore it is reasonable to argue that this decline will have a similar effect on the real economy. The same is true for water scarcity and deforestation. It is important to include all of society to make it a just transition, as well as asking what role a central bank and supervisor can play in that regard. People tend to enter an atmosphere of political sensitivities around things that are mostly relied on by governments or that governments are initially responsible for.

A regulator stated that the mandate is ESG. The regulator's organisation has been focusing its efforts far much more on the 'E' of ESG than on the other initials because that is the area where urgent work needs to be done. There is a complex issue in terms of getting the data and the risk management tools right. If the framework is not sufficiently well accepted and harmonised, then there is a great risk that firms will jump the gun to some extent under the pressure of investors and different groups. It is important that firms, investors, and customers should be in a good position to assess not only what the situation is now and what is known about it, but also what it has a hard time knowing about it.

An industry representative stated that carbon pricing would help address ESG, but it has a subset. There is a need to have greater price and data transparency across everything. It does not just concern emissions and carbon pricing; it concerns natural capital and how to put a proper value on price. There cannot be healthy banks unless there are healthy economies, and there cannot be healthy economies unless there are healthy societies. Society does not have room for Basel III or Basel IV when it comes to the climate.

3. The top priorities of the panel

Panellists stated that their top priorities are temperature alignment, disclosure, a uniform standard, roadmaps, adaptation, not to overshoot the 1.5-degree temperature increase, and carbon markets.