RENEWED EU SUSTAINABLE FINANCE STRATEGY

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The renewed strategy: consolidating the EU sustainable finance policy framework

The impact of climate change and environmental degradation is already very visible to us all, with far-reaching human and economic consequences for our societies. Unprecedented and parallel efforts in a number of areas are needed to mitigate the multiple causes of these risks and to adapt to the new situation as swiftly as possible. To address this, the Commission has recently adopted a package of policies with the aim of reducing net greenhouse gas emissions by at least 55% by 2030.

Besides policy measures, significant public and private investment is needed. The EU will need EUR 470 billion yearly in additional investment to reach its 2030 climate and environmental targets. In addition, to remain sound and stable, financial institutions will need to fully integrate climate and environmental risks and sustainability considerations in their financing decisions. Through this, financial institutions have the potential to accelerate the ecological transition of the real economy.

For this reason, the Commission - with its 2018 Action Plan - laid the foundations of a sustainable finance policy framework[1]. Since then, the EU has put in place three key building blocks: a common classification system, or 'taxonomy' for sustainable activities; a disclosure framework for investors, non-financial and financial companies; and a number of different investment tools, including green benchmarks, standards and labels.

While this is a necessary start, it's clearly not sufficient. The strengthened environmental targets of the European Green Deal need to be translated also in the financial sector. At the same time, the global context is evolving rapidly. The EU's renewed strategy for sustainable finance identifies four main areas where additional actions are needed for the financial system to reach our climate and environmental objectives.

First, the transition pathways of economic actors will vary considerably, with different starting points and different business strategies. Until now, EU efforts have predominantly focused on supporting investment flows towards economic activities that are already sustainable. The Commission will explore additional actions to recognise and support investments in intermediary steps on the pathway towards sustainability. The EU Taxonomy is helpful in this context, as are new labels and standards for financial instruments and products.

Second, to be successful, the transition needs to be inclusive. Citizens, SMEs and public authorities need specific support tools to have access to sustainable finance opportunities. Beyond these specific actors, horizontal policies can improve the inclusiveness of the transition, such as exploring the role of digital sustainable finance, the definition of trustworthy social investments, or a greater protection from climate risks.

Third, the financial sector itself will need to become more resilient to the risks posed by climate change and environmental degradation, and to improve its own contribution to sustainability. The strategy aims to improve the integration of these risks in reporting standards and credit ratings, to ensure that ESG factors are included in the risk management systems and supervision of banks and insurers. The strategy also supports an increased contribution of the financial institutions to sustainability, using for instance financial institutions' target setting or voluntary commitments and the integration of sustainability impact in the strategies and investment decision-making processes of investors. Measuring the progress made by the financial sector as a whole to achieve our climate and environmental goals will also be important.

Finally, global ambitions to address climate and environmental challenges have significantly increased. The EU is at the forefront of global efforts in this area but cannot succeed alone. The Commission will continue to work with its international partners and advocate an ambitious consensus on global sustainable finance standards. The International Platform on Sustainable Finance (IPSF), which the Commission pilots together with 16 other jurisdictions, will deepen its work on taxonomies, labels and disclosures. Finally, the Commission intends to develop a comprehensive strategy to help increase sustainable finance in low- and middle-income countries.

The renewed strategy is an important extra step in our collective endeavour to achieve a more sustainable financial system and builds on the measures already in place. The intention is also to identify new business opportunities and increase the overall resilience of the financial sector. It goes without saying that these once-in-a-generation systemic changes and the limited time available to meaningfully reverse the current climate trends, bring new challenges. But the price of our inaction for future generations would significantly exceed these challenges.

[1] Communication from the Commission 'Action Plan: Financing Sustainable Growth', COM(2018) 97 final, 8.3.2018.

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The new EU Sustainable Finance Strategy is a right step in a long journey

Today, we are living through a remarkable period of history. The global cash flows are being gradually channelled in a sustainable direction, and green finance is trending in financial markets. Additionally, the EU Commission introduced its second, renewed Sustainable Finance Strategy for the EU in June 2021. This strategy continues the work of greening the EU financial legislation that started in 2018 and is aligned with the targets set in the EU's newly released 'Fit for 55' climate package. Whereas the main purpose of the 2018's strategy was to present the concept of sustainable finance for the first time to the EU legislators, the new strategy seems to take a major leap forward by proposing a wide set of concrete, polished tools to make the EU financial markets sustainable.

The direction is now right but there is still a long way to go. Firstly, in order to achieve a coherent methodology for measuring sustainability impact across the EU, the EU needs common financial reporting standards. However, when creating these standards, the ambition needs to be set high enough by involving all relevant stakeholders in the standard-setting process, such as companies that report, investors, NGOs, trade unions, as well as bodies including of the UN (UNPRI, UNEP, UNDRR), the European Environment Agency, Eurostat, and so forth. Hence, we could ensure that the standards will follow science-based and futureproof targets, and that those would not perform worse than already existing practices in the markets. Secondly, the company reports that would base on these standards need to be compiled under a common register in a transparent and comparable manner. The most relevant database for that would be the European Single Access Point (ESAP), an initiative introduced by the EU Commission in 2020 as part of the CMU action plan that would gather the financial and non-financial information publicly disclosed by companies.

Not only the private money matters, but also the public sector, including the EU and national budgets need to be involved in non-financial reporting under the same harmonized standards. Additionally, the non-financial reporting does not only limit to environmental issues, as the whole ESG criteria set (environment, social, governance) needs to be visible in those reports. A top-down approach is needed within the company, and both environmental and social due diligence should be included in the list of responses of corporate management and board, for securing adequate levels of meticulousness and responsibility of the business.

From the climate point of view, we cannot afford unsustainable investments any longer.

Finally, the examination and implementation of different risk concepts should be in the core of any EU sustainable finance initiatives. Last year the risk of a global pandemic became reality in the modern world and caused an unprecedented shock to our economies and societies.

The future risks are manifold and even difficult to predict, but I prefer using the concept of 'triple materiality' that gives the most accurate definitions of different types of risks. The first level of triple materiality is financial and technical risks that might have potential impacts on the credit or liquidity of the company.

Secondly, there exists the level of environmental risks including the operational risks, such as potential accidents, and new hazards emerging from climate and environmental changes that have a direct impact on the business.

Lastly, the third and most invisible, though the most important level is the biodiversity risk. It means that if you are increasing and intensifying climate change, biodiversity loss and resource overconsumption yourself, you are both gradually destroying your own business environment and the planet. However, if you are supporting the transition towards climate neutrality, you will also create a sound and successful business environment for yourself. Being thus part of the solution is a win-win.

As a summary, first we need to create a science-based, transparent and harmonized global system for comparable data. Secondly, with this data the sustainability risks need to be assessed thoroughly in system risk analyses, also by credit rating agencies. These assessments, as well as the whole materiality concept should be reflected in banking sector and lending decisions, and capital risk buffers. Thirdly, we need to establish a global sustainable finance framework in both public and private sectors with adequate flexibility, and try to safeguard this framework from political manoeuvring and manipulation.

According to estimates, the climate crisis will cost us $1 quadrillion over the next 80 years if we fail to meet the terms of the Paris Climate Agreement. Moreover, it makes the yearly sum even more than twice per year of what the COVID-19 crisis is hitting us with now. From the climate point of view, we cannot afford unsustainable investments any longer. Sustainable finance is the key to tackle climate change and preserve biodiversity, and we have no time to waste.

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ESMA's views on next steps for Sustainable Finance

Climate change is the challenge of our time. We are already witnessing more extreme weather, as fires and storms increase in frequency and intensity. To limit the global temperature rise to well below 2 degrees Celsius, as outlined in the Paris Agreement, efforts are needed in all economic sectors. The financial sector can provide opportunities for citizens, financial institutions and corporates to have a positive impact on sustainability and must itself manage and reduce risks relating to environmental, social and governance (ESG) factors.

ESMA is eager to contribute to the development and consistent application of a comprehensive sustainable finance framework and supports the Commission's ambitious agenda.

Such a role has been clearly spelled out when the ESAs' Review introduced sustainability as an integral part of ESMA's mandate. In early 2020, ESMA adopted its Strategy for Sustainable Finance which foresees taking ESG factors into account across the activities of rule-making, risk assessment, supervisory convergence and direct supervision.

Since the Commission adopted its first action plan on sustainable finance in 2018, significant progress has been made as policy makers have adopted legislation on classifying sustainable activities, on sustainability disclosures and on climate benchmarks. ESMA and the ESAs, where required, have been preparing related technical requirements and are monitoring the gradual implementation by the market of the new rules. ESMA will also continue its work to ensure that the massive shift towards increased financing of sustainable activities is conducted in a way that does not harm investor protection, orderly markets or financial stability.

In July, the Commission published its updated strategy for financing the transition to a sustainable economy. Going forward, more work is expected in various areas, including on the taxonomy to define activities that can be deemed sustainable. Another key building block of the European sustainable finance framework is the design of appropriate disclosures regarding corporates' activities from a sustainability perspective. The proposal for a Corporate Sustainability Reporting Directive is an essential step to achieve more comparable, relevant and reliable information to be reported at corporate level.

ESMA is eager to contribute to a comprehensive sustainable finance framework.

ESMA considers that further action is needed as the market for ESG ratings and other assessment tools is currently unregulated and unsupervised which presents risks of greenwashing, capital misallocation and products mis-selling. ESMA has therefore advised the Commission to propose minimum standards for ESG ratings including supervision. A common definition of ESG ratings that covers the broad spectrum of possible ESG assessments on offer would help future-proof any regulatory framework. The regulatory regime should be adapted to the current market structure and accommodate both large multi-national providers who may be subject to existing regulatory frameworks, as well as smaller entities.

Effective supervision and enforcement are key to ensure that the financing of the transition happens across the sustainable investment value chain, in full confidence of investors at the different stages. Direct authorisation/supervision at EU level for specific actors, as well as the effective use of the ESAs' supervisory coordination function will contribute to building comprehensive supervision across the EU.

Last but not least, to prevent green-washing, ESMA is planning convergence work to ensure consistent supervision of applicable rules as financial products offered to investors are more and more presented as sustainable or ESG. Labels can also help investors make sustainable choices. The Commission's recently presented EU Green Bonds proposal is welcome and ESMA stands ready to take on board supervisory responsibilities for third party verifiers.

As many initiatives are taking place simultaneously, it is of utmost importance to ensure consistency across pieces of regulation and proportionality in requirements for smaller companies, to ensure they can comply and show how they contribute to a more sustainable future, in a manner that is useful and adapted to their activities.

Finally, while a lot can be achieved at EU level, both financial markets and sustainability challenges are global and require global cooperation and action. In this respect, the International Platform on Sustainable Finance plays an important role to promote international convergence. ESMA participates in and contributes to the work of IOSCO, FSB and the Network for Greening the Financial System (NGFS). In addition, ESMA welcomes the initiative of the IFRS Foundation to consider establishing a board to develop sustainability standards, as international standardisation could facilitate cross-border sustainable investments. While this work would create a common global basis which will promote consistency and international convergence, more ambitious approaches in certain jurisdictions would still be suitable when they are in different stages in their sustainability efforts.

Taken together, the actions at EU and international level will be big steps forward to facilitate and promote sustainable investments to support the transition.

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Helping the transition towards sustainable banking and finance

Banks and investors are integrating sustainable finance into their business at a quickening speed. Although there are many "drivers" – in particular the regulatory environment in encouraging environmental, social and governance ("ESG") focus – it is increasingly investors' appetites for "green finance" that is key. Financial institutions, including the SMBC group, are reacting to investor demand by providing a range of sustainable offerings, from well-established "green bonds", to newer products such as "green deposits" and sustainability-linked loans. However, there are clear challenges ahead which, if not addressed, threaten to strike at the very heart of governments' green initiatives. Policymakers will be aware of these challenges, but if not addressed they could destabilise the transition path that many financial institutions have embarked upon and have a collective interest to see succeed.

1. Encouraging clear, consistent, and globally comparable standards

The transition towards sustainable finance would undoubtedly be assisted by the existence of similar and, therefore, comparable rules in the key global markets. Although there are signs of collaboration between policymakers on sustainability issues, there is at present no "global ESG standard". Banks and investors therefore face a challenge when trying to understand what "sustainability" means when applied to financial services and the launch of new products. An emerging question is whether there should be a standardisation of sustainability criteria across jurisdictions.

The EU has taken a lead globally by launching:

- A "European Green Bond Standard" as part of its sustainable-finance strategy, setting a voluntary "gold standard" for green bonds;
- A "taxonomy" of sustainability in financial services, under the EU Taxonomy Regulation; and
- Sustainability disclosure requirements under the EU Sustainable Finance Disclosure Regulation.

These initiatives promote sustainability-related disclosure within the EU; however they do not neatly match with disclosure requirements which are emerging in other parts of the world, including in the United States and Asia. Although it is also important to have the necessary frameworks and standards in place that reflect the particular situation relevant to each region, it is difficult to imagine a better issue for broadly consistent global standards than a truly global topic, such as climate change.

> An emerging question is whether there should be a standardisation of sustainability standards.

2. Avoiding "too much too soon"

The urgent need to address climate change has led to a mountain of sustainability rules and policy initiatives. These have been published within a reasonably short timeframe, and many of them have imminent compliance dates. It is hoped that policymakers and regulators will continue to bear in mind the need for rules to be published with sufficient time to allow the financial services industry to fully consider, digest, and be able to consider holistically the impacts of sustainability rules on their business.

Together, current EU initiatives require hundreds of data points to be produced. New rules also need to dovetail themselves into an already complex landscape of sustainability requirements. Acknowledging the risk of "too much too soon", the EU has delayed the implementation dates for some aspects of these rules, such as the EU "taxonomy" requirements.

While financial institutions with a strong ESG focus such as SMBC will naturally seek to deploy the relevant resource to address incoming regulation and identify the opportunities in sustainable finance, there is the concern that some actors may seek to "greenwash" their compliance where they cannot meet requirements in time, by over-stating the sustainability of products. This would have negative systemic consequences to the extent that the market is flooded with assets that are marketed as sustainable, but which fall short of the required standards. This would also undermine the trust that is fundamental to sustainable finance.

3. Avoiding reversals in policy

Sustainable investing is a relatively new area of regulation, which builds upon previously understood concepts, such as environmental and social "stewardship", and uses a new array of tools, such as "taxonomies" to ensure that the sustainability rating of investments is measurable.

With all new rules, however, there is the danger that they may be calibrated incorrectly and need to be adjusted. Developments in science may also require rules to be re-considered. It is hoped that, where possible, policymakers and regulators will seek to ensure that any changes to existing initiatives take place in a measured way, with sufficient notice to the market, and that such changes will be relatively infrequent.

The transition towards sustainable banking and finance is far from an easy task, and it will require concerted and consistent effort from policymakers, regulators, and the industry – at a global level – to ensure that we achieve success.

JUDSON BERKEY
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Finance and broader economy need to align to transition to a sustainable future

The 2018 Action Plan is the EU's ambitious commitment to channel private financial flows towards investments that support the Paris Agreement target of a carbon-neutral economy by 2050, and more broadly the United Nations Sustainable Development Goals.

The plan lays out a comprehensive set of policy objectives to realise that ambition, including reorienting capital flows towards a more sustainable economy by establishing a classification system for sustainable activities – the EU taxonomy - mainstreaming sustainability into risk management, and strengthening sustainability disclosure and accounting rulemaking.

The Renewed Sustainable Finance Strategy doubles down on that ambition, identifying four areas where additional action is needed for the financial system to fully support the transition to a sustainable economy:

1. Tools and policies to finance transition plans and reach climate and other environmental goals
2. Access to sustainable finance for individuals and SMEs
3. Supporting the financial sector in contributing towards meeting the EU's Green Deal targets, becoming resilient, and combating greenwashing
4. The promotion of global collaboration and an ambitious global sustainable finance agenda

And here lies the challenge. Ambition is great but it is imperative that policy actions match the ambition. We must not be bogged down by well-intentioned, but unfit for purpose, regulatory frameworks. We also need to ensure alignment between financial sector and real economy mandates.

While we recognise that a green taxonomy can be the cornerstone of sustainable finance in enabling the financing of the transition, the taxonomy in its current form is too binary and does not adequately support the transition from a negative environmental impact activity to a low impact activity.

Finance and broader economy need to align to transition to a sustainable future.

The taxonomy needs not only to recognise activities classified as 'green', it should also reflect but also activities which are making the transition towards greater sustainability. Helping high-carbon companies shift towards net zero emissions is a vital part of combating climate change and banks, investors and policymakers must step up their support. Thus, we appreciate the recent proposals from the International Platform on Sustainable Finance (IPSF) to extend the Taxonomy framework.

Finance does not stop at EU borders. Thus, a globally aligned and comparable taxonomy is also critical for scaling up the flow of private capital towards environmentally sustainable investments and unlocking transition finance.

Hence it is of paramount importance that EU and global policy makers take due consideration of the work being done by the IPFS highlighting the commonalities between the various taxonomies currently in existence, all of which seek to classify a given economic activity with environmental goals. By so doing, they aim to develop a common ground taxonomy, which in turn will enhance transparency about what is commonly green in member jurisdictions and significantly contribute to the scaling up of cross-border green investments. We also encourage alignment of activities through the Financial Stability Board and G20 roadmaps.

The current alphabet soup of ESG reporting and disclosure standards does not allow for meaningful comparison of companies and thus sustainable finance flows. The proliferation of reporting standards not only increases regulatory obligations, it also adds to investor confusion, potentially jeopardising the reorientation of capital into sustainable investments.

The development of a common sustainability reporting standard is imperative if we are to progress to a situation in which sustainability information has a status comparable with that of financial information.

This is a matter of urgency and so there is no time to waste.

The IFRS Foundation's programme of work to develop a baseline global reporting standard for sustainability, which jurisdictions can then further supplement, is critical to fostering global best practice and accelerating convergence.

Sustainable finance policy is in its infancy. Any framework should allow for flexibility and innovation, leveraging and seeking collaboration through existing structures. This is a multi-year undertaking which requires the appropriate sequencing of regulatory measures. While we recognize that some jurisdictions will push ahead in parallel with the international work it is critical that the efforts speak to each other and align over time.

Finally, the ultimate goal is not only a sustainable financial sector but a sustainable economy. Finance cannot do it all on its own. Real economy companies need policy frameworks and incentives to re-engineer their production processes. Such frameworks also provide the certainly finance needs to make investments. Thus, we welcome the Fit for 55 package and look forward to its rapid implementation to support the transition to the sustainable economy and society that we need.

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Walking the tightrope – what is at stake in the renewed sustainable finance strategy?

The EU's Renewed Sustainable Finance Strategy (RSFS) stands squarely on the shoulders of its predecessor, the 2018 action plan on sustainable finance. It utilises the building blocks already established – in particular the work on the EU Taxonomy and the expanding disclosure regime, including the Sustainable Finance Disclosures Regulation (SFDR). Three years on, much has been achieved but successful implementation of the RSFS is crucial if the EU is to meet its ambitious sustainability goals, including a 55% reduction in greenhouse gas emissions by 2030 from 1990 levels. It comes amid an emerging consensus that, without unprecedented policy intervention to create the right incentives, it is unlikely enough financial flows will be redirected to support the necessary transition to reach global sustainability goals including the Paris Agreement.

For those passionate about financing a sustainable economy, there is a lot to like in the new strategy, from a greater focus on retail investors and small businesses to increased supervision of sustainability risk management processes of banks and insurers.

The need for global cohesion is clearly recognised, answering the calls of those concerned by potential fragmentation in reporting frameworks. The EU has established itself as a leader and can play a key role in keeping ambition high. Global collaboration also offers an opportunity to improve the data that feeds into financial firms' EU-mandated SFDR disclosures.

Perhaps most important is the focus on increasing flows towards financing the transition to a sustainable economy. The EU had previously focused on what is already 'green'. For asset managers such as ourselves, it is particularly encouraging to see that for the first time the Commission recognises the crucial role that investor stewardship has to play in this transition. This is evident in a number of places in the strategy, including the commitment to clarify the fiduciary duties and stewardship rules of investors to reflect the financial sector's contribution to Green Deal targets, and a review of the Shareholder Rights Directive (SRDII). The notion of a transition is also reflected more clearly in the proposed expansion of the Taxonomy framework, such as through recognition of intermediate performance levels. The Taxonomy itself can be a tool for investors to engage systematically with companies on setting targets and transition plans.

The Commission will need to use all the tools at its disposal.

Such an ambitious strategy is naturally not without its challenges, and there are some balancing acts to be performed. If the EU is to reach its sustainability goals, rapid action is needed. Yet equally, care must be taken with sequencing to ensure a coherent regulatory framework.

Lessons can be learned from the last three years, where the parallel development of the Taxonomy and SFDR frameworks created inconsistencies, and detailed SFDR disclosure standards have been delayed twice. The RSFS announces the Commission will be further reviewing aspects of SFDR. This has created uncertainty for investors. The EU must strike a balance between quick action and a clear and coherent framework that incentivises the right behaviour. On the global stage, the need for cohesion may be challenging to balance with the EU's level of ambition and focus on double materiality.

The next challenge will be to maintain the credibility of the Taxonomy as it expands further. This is crucial as it underpins other initiatives including the proposed EU Green Bond Standard. The Taxonomy must be seen to be science-based and led by expert advice, after accusations of politicisation caused some turbulence before the first Delegated Acts were published.

The complementary Climate Delegated Act is likely to become a focus of debate, particularly in relation to the potential inclusion of natural gas. The Commission will need to be able to justify the inclusion of any controversial activities.

And finally, we return to stewardship. Whilst it is promising to see this reflected in the strategy as a key lever to aid the transition, it may ring alarm bells for some. A 'tick-box' disclosure framework could restrict innovation and flexibility to tailor the approach to a fund or firm or encourage boilerplate statements. It is therefore crucial that the EU takes a principles-based approach. The UK Stewardship Code 2020 is a strong example of this. It sets clear standards for disclosure to create comparability and a level playing field, without prescribing a particular approach. Whilst there are opportunities in the revision of the SRDII - including to broaden the scope to cover all asset classes – a principles-based EU Stewardship Code could go above and beyond this, allowing more flexibility and focusing on implementation and outcomes rather than just policies.

The RSFS is a strong statement of intent from the Commission. But it all comes down to the implementation, and the Commission will need to use all the tools at its disposal – not least leveraging investor stewardship – to achieve its aims.