6 years after the Paris Treaty: is the financial sector fully playing its sustainability role?

1. Commitments need to give way to actions – What has been said and done following the Paris Agreement and COP26

The Chair highlighted the importance of the Paris Agreement. The ultimate objective is enormous: to reduce greenhouse gas emissions and limit the global temperature increase. An industry representa-tive noted that from COP26 over 100 banks globally have committed to net-zero objectives, but those commitments now need to be translated into action.

A regulator added that COP26 saw the launch of the International Sustainability Standards Board (ISSB). Ultimately, if one global baseline is needed, a building block approach is required. Climate is the starting point, and carve-ins and carve-outs will have to be accepted. It is about the principle of subsidiarity and the capacity of states to implement this important framework.

A regulator stated that progress in the current year was made in collaboration with industry and part-ners around the world. The COP26 commitments are ground-breaking. There was a commitment from 450 financial institutions in the Glasgow Financial Alliance for Net Zero (GFANZ) for $130 trillion in assets to be climate-aligned. The question is whether these commitments will be translated into con-crete action in terms of investments and supporting the transition. A UK Financial Conduct Authority (FCA) survey of asset managers showed that 75% made a commitment to net zero, but only 38% had a specific target. Likewise, 90% of companies had committed to taking action but only 30% had a long-term quantitative target for reducing their greenhouse gas emissions.

An industry representative noted that the Glasgow Financial Alliance for Net Zero harnesses ambitions and creates an environment where there is pressure and support to set more ambitious targets and then, with those goals, to drive technological innovation and the new financing needed to bring sys-temic change.

2. The financial sector has a major role to play in the implementation of the Paris Agreement

A central bank official stated that the financial sector plays a crucial role in mitigating climate change. An industry representative suggested there are three main areas where that needs to happen.

The first is in the work that banks need to do with their clients to enable the transition to a low-carbon economy. The mobilisation of capital is vital to this, and banks play an important enabling role here, both in helping a wide range of businesses manage the transition and physical risks they are exposed to, and also in realising the opportunities of a transition to a green economy. Banks will play a vital role, and this is where many institutions are now focused on developing their business strategies.

The second area is in managing the transition and physical risks that banks and financial services firms are exposed to through the risk of their counterparties and their clients. That has been a major focus of the regulators thus far.

The third area is transparency. This does not just apply to banks and financial services firms but to all organisations, in particular, those who have made net-zero commitments. There will be increased scru-tiny over for how these organisations are managing the transition to a low-carbon economy, and how they are furthering environmental, social and governance (ESG) objectives more generally.

A public bank representative indicated that the financial sector does not play a sufficient role in incen-tivising households' and firms' transitions. An industry representative added that the financial sector is working to get there, and it can and should be a driving force for a sustainable transition. It can use its position and expertise to help customers move in a more sustainable direction through advisory services, financing and clear requirements.

3. Challenges – Stronger involvement is needed on several levels

A central bank official highlighted three figures from the European Systemic Risk Board (ESRB) and the European Central Bank (ECB) report from last July. First, she noted that 14% of the collective euro area banking sector balance sheets are exposed to high-emission firms. Second, for euro area investment funds, exposure is clearly oriented towards carbon-intensive projects or industries, with over 55%. Third, different studies show the economic impact of not taking ambitious action to miti-gate climate change. Failing to limit global warming could result in a double-digit decline in global gross domestic product (GDP) by 2050. The question is who will finance the transition. Currently, there are not enough financial flows into sustainable companies or sustainable projects.

An industry representative emphasised that the industry is nowhere near where it needs to be. The underlying assets are not there for the banks to finance and for investors to fund.

3.1 The financing challenge of the transition

A central bank official noted that Europe's financial system is mostly bank-based, so the banking industry plays an important role. The transformation hinges on innovation and new technologies. De-veloping these innovations requires a certain risk appetite since only one out of 20 start-ups will suc-ceed. The risk appetite of the banking industry is limited. The question then is who will do the job and where the money will come from. The capital markets will play a vital role. If Europe does not manage to deepen its capital markets, it will not manage the transition.

In emerging and developing countries, the public sector often plays an important role in financing projects. The fiscal capacity of emerging markets is very strained. Here, it is therefore important to create an environment that will be conducive to more private capital for emerging countries.

An industry representative noted that different types of transition financing, like sustainability-linked loans and bonds, are important instruments. They are designed to encourage a move towards a more sustainable economy by rewarding borrowers for improvements in their impact on the planet. An in-dustry representative remarked that retrofitting existing infrastructure and building new, clean infra-structure will require in the range of $7 trillion per year. There is a gap of around $3-4 trillion.

3.2 Risk taking

An industry representative highlighted the considerable financial risk for first-mover companies and financial institutions involved in investments in innovative and sustainable technologies. Projects that are necessary to drive the sustainable transition are often deemed too high risk and are not priori-tised. There is therefore a need to investigate new and innovative financing and risk-sharing measures to overcome this barrier.

3.3 Access to climate and green data

A regulator noted that the financial sector and other investors are in need of more data from compa-nies to understand what they are doing to reduce their emissions and how climate matters affect their enterprises.

An industry representative stated that about 40% of companies out of a universe of several thousand of the largest listed companies globally have a target but only 3% have targets that are aligned with Paris and with net zero. An industry representative emphasised the importance of standardising ESG data and its availability. An industry representative noted that one is on the data side. What the indus-try measures is going to be critical to how it manages, and the quality, quantity and consistency of data is going to be vitally important. There is also the question of how banks and financial services firms are managing this through their data architecture.

3.4 The regulatory challenge

A regulator stated that investors are not interested in countries competing against each other. They want one global set of standards.

An industry representative remarked that whilst there are many commitments on the market it is not the whole market, so there is a risk of a two-tiered economy where large companies have green port-folios while brown assets will continue to be funded by smaller entities without the same commit-ments. There must be a path to take those dirty assets towards the energy transition and to recognise the progress made inside portfolios, rather than an expectation of a binary switching.

A public bank representative stated that prudential rules must be practical. An industry representative noted the potential for regulatory complexity and fragmentation, particularly for global firms. Manag-ing that is not just for legislators and regulators; the industry also has a responsibility to maintain that dialogue.

An industry representative noted the need for clearer national policies, priorities and targets for scal-ing low-carbon solutions along with incentives. The UK is thinking about a climate test for every new policy, which is a good way to put climate at the centre of policy-making and ensure alignment. There are often regulations conducive to more investment in renewables while the same economies also have fossil fuel subsidies. Avoiding this type of misalignment is very important.

3.5 Transparency challenge

A regulator emphasised the importance of disclosure so shareholders, clients and consumers can hold companies to account on their key performance indicators (KPI) and milestones. A government official added that the peer pressure and the competition created by maximising transparency will add to the instruments.

3.6 Letting go of old habits

A public bank representative confirmed that there has been progress, but nothing compared to what is happening at present because this is a transformation rather than a transition. It is not just econo-mies and the finance sector but societies that are transforming.

The industry cannot and shall not behave as if it is business as usual, but most are looking at the situation with a business-as-usual perspective. The real question is whether there is readiness to ac-cept the effect of the transformation on society, which will mean a lower return on investment, much more risk and less money being earned; the finance of tomorrow will not be the same or have the same returns as the finance of yesterday.

An industry representative noted that it cannot only be the greenest projects and activities that are rewarded; there is a need to drive the transition, and this means incentivising households' and firms' transitions from brown to light brown, to light green and ultimately to dark green. An industry repre-sentative stated that the transition is also about creating career pathways for young people joining industry organisations as graduates. There is a real opportunity for them to build their careers in the sustainability space.

Financial services tend to be a relatively insular profession where there is a great deal of technical jargon, and it can seem quite impenetrable to outsiders. The industry needs to involve a broad and diverse range of skills if it is going to make progress in the transformation needed to move to net zero. There should be participation within financial services firms from professions and backgrounds that bankers or asset managers would not normally think of to drive forward the cultural change need-ed.

Several speakers agreed that the other regulatory incentive for financial regulation is CO2 pricing. A central bank official suggested that implementing an adequate carbon pricing scheme is crucially important, while acknowledging that carbon taxation alone will not lead to a carbon-neutral planet. The focus should not only be on ESG labelling. It is not about giving the money to those sectors that are already green; it is about financing the transformation, especially for brown companies. An industry representative emphasised that what is also important, in addition to universal carbon pricing, is a carbon border tax adjustment.

4. A regulatory framework building over time: Starting from scratch with ups and downs because the transition will take time

An industry representative stated that there is significant focus from regulators and policy-makers on standardising and improving the quality, quantity and consistency of data provided into the markets. There needs to be a genuine shared effort across the private and public sectors to ensure that the rules of the game are consistent, transparent and science-based. To succeed in the path to achieving the Paris goals, those rules need to be set in a way that enables the right kinds of competition in the right kinds of areas.

A regulator remarked that the new legislative package on sustainability, comprising the Sustainable Finance Disclosure Regulation (SFDR) and Corporate Sustainability Reporting Directive (CSRD), is very challenging. It is an impressive wave of new regulation and it will take some time to digest. Usu-ally, regulators are asked to develop new regulations following a crisis. That is not the case on this occasion; there is only a very impressive demand-driven exercise. There are perhaps too many expec-tations but the position is one of starting from scratch, which is a terrific advantage.

A regulator noted that the UK has established a Transition Plan Taskforce bringing together scientists, regulators, industry, civil society and academia to develop a 'gold standard' for transition plans, sup-porting the transition towards the ambition to be a net-zero financial centre.

There is also the role of shareholders and of investor stewardship. There is some concern that if regu-lators go too far, all of the assets that need to transition over many decades will be moved into pri-vate markets where there is much less scrutiny. This is where an intelligent conversation with investors is important so they have the ability to vote and add their voices to the transition progress, while rec-ognising it is going to take multiple decades.

A government official noted that their organisation will hand standards and forward-looking methods to its financial intermediaries to provide them with an instrument to identify the global temperature path they are on. Having a measurement other than CO2 was the big achievement of the Paris Agree-ment. Someone with a 3-degree portfolio can ask whether they shape it in a certain way or include the promise of a development path of transition in the portfolio, or query whether it is a hopeless portfo-lio. The aim is to have a system that incentivises the markets to see there is huge potential and to see the benefits to be drawn from a bad portfolio with regards to the future.

5. The need for collective action with a specific role for the public and private sectors

An industry representative highlighted shared action pathways and the need for the whole system, private sector and governments, to move in the same direction.

A public bank representative noted that François Villeroy previously said there is readiness to invest for the long term if protection for the capital is given, and this protection should be provided not only by the public sector but by all. Public and private actors have specific roles and cannot behave alike. The public actors have a leverage role to play, and for that they need to have more room to act.

An industry representative noted that the public sector has a huge role to play in helping to scale new technologies that will be critical for decarbonisation.

6. Disparities in the transition process between countries

An industry representative stated that emerging and developing countries are responsible for approx-imately two thirds of greenhouse gases. As in the developed market, growth in emerging and devel-oping countries has been CO2 intensive, especially over the last 20 years. From 2000 until 2017/2018, the CO2 intensity in emerging markets has increased. About 44% of greenhouse gas emissions are coming from coal-fired power plants in emerging countries.

At the same time, fossil fuel growth has been good for the poor. Hundreds of millions of people have been lifted out of poverty because of this growth, fuelled by relatively cheap sources of energy. The critical question going forward will be how to achieve a decoupling between the cleanness of the growth and the growth itself.

Risk sharing is also needed. There is a great deal of risk in emerging countries. There are many issues related to

aggregation. Development finance institutions (DFI), the World Bank, the International Fi-nance Corporation (IFC) and many others have vital roles to play in working with the private sector to look for mechanisms that will allow the mobilisation of finance at scale.

A wider and more consistent framework is required to understand and manage risks and to drive real convergence between the various standards. The EU is an extremely important place for doing that. It has a major opportunity to show leadership, but this needs to be done in line with market expecta-tions and with understanding of the needs of emerging markets, which are not necessarily fully aligned with the EU. The international platform for sustainable finance led by Europe, which is reach-ing out to many important countries like China and India, is an example of the things that will drive the necessary convergence.

7. The phenomenon of greenwashing and how to cope with it

A regulator confirmed that greenwashing is a real problem of significant magnitude which requires collective attention. Public support for the mobilisation of finance to deliver net zero could be signifi-cantly undermined if regulators do not ensure they are ahead of the issue.

One area for which the industry is asking for regulation is ESG ratings, because they are seeing a proliferation of standards and a lack of consistency. Fund managers and boards of funds have been written to in order to ensure they have proper governance around this. This will be a major theme for the next couple of years.

A regulator noted that issues are being worked on jointly which means going into the detail. Regula-tors have to be able to tackle all of the detail otherwise they are not able to discuss with the Financial Stability Board (FSB). If attention is not paid to greenwashing it will be a serious boomerang problem.

One of the sources of greenwashing concerns the mismatch of the implementation of the different regulations at the EU level. ESMA states: ‘Regulatory arbitrage linked to the fast-evolving legislative framework aggravate greenwashing risks…’ There is a need for caution. The Financial Transparency System (FTS) still needs to be endorsed. This means that there is for now only self-obligatory filing. Once FTS can be enforced it will be.

One of the solutions is to take responsibility and to perform, ex ante, marketing. This is about optics. With very aggressive marketing material when there is a problem of mismatching there can be a seri-ous problem for trust. From this perspective, responsibility has to be taken because it is about trust. That is very important because whenever it is possible to check the quality of marketing materials it means that cases of mis-selling, from a statistical point of view, are reduced. However, it is a day-to-day challenge. Greenwashing has to be managed seriously, because it is about trust. If it is not, that would be a serious issue.