European Financial Services Round Table

October 2021

EFR PAPER ON FINANCING THE TRANSITION TO A SUSTAINABLE FUTURE

Introduction

The financial sector plays an essential role in financing the transition to a sustainable future. In order to achieve a broad transformation of the economy, the majority of sustainable funding has to go to projects and industries of the real economy that still need to make the transition. In parallel, the financial sector itself has many stakeholders who will assess whether a financial institution is indeed contributing to the sustainable finance agenda and complying with corresponding rules: first and foremost, EU regulators and supervisors, but also credit rating agencies, accounting standard setting bodies and NGOs who will scrutinise pathways to transition.

Incentivising investment in the transformation of companies should be prioritised and the overall policy framework needs to support such transitional pathways. In order to steer sustainable investments successfully, as well as to identify and manage sustainability risks correctly, the availability, high quality and comparability of sustainability data is essential. Beyond improving data quality, the EU and the Member States should implement a meaningful price on carbon emissions and advocate for pricing carbon globally. This will align economic incentives with reduced carbon dependency and help decouple economic prosperity from carbon emissions.

An enabling transparency and disclosure framework to inform markets, authorities, and society at large is needed, but the tools to evaluate companies' transition paths towards more sustainable activities are still work in progress at European level and at international level. EU companies with global portfolios need consistency and convergence between the various standards under development. In this respect, it is important that the EU contributes to the process of convergence of sustainability reporting standards at global level. The International Financial Reporting Standards (IFRS) Foundation's work on developing climate-related reporting standards based on FSB Task-Force on Climate-related Financial Disclosure (TCFD) recommendations should be completed quickly and adopted globally.

Policymakers have to encourage the market to invest in sustainable assets while maintaining the key principles of risk-sensitivity and financial stability in prudential regulation.

While the financial system is an important element in the economic transformation, the ultimate goal is a sustainable economy. Policy actions should therefore be balanced between the financial system and broader economic actors. The willingness and capacity of the financial sector to finance sustainable projects/investments is significantly above the availability of suitable/bankable/investible assets. A pipeline of sustainable investments is needed. Real economy companies need incentives to re-engineer their production processes and reliable policy frameworks which in turn provide some of the certainty financial actors need to make investments. We welcome the Fit for 55 package and ask for its rapid implementation in order to support the sustainable transition.

In order to improve resilience, EU Member States must step up the protection against physical risk from climate change by means of insurance coverage and adaptation measures. To inform a clear understanding of physical risks, governments should promote investment in climate adaptation measures and support insurability, while establishing a voluntary public-private risk hub for granular data sharing of climate-related risks. Furthermore, governments should pre-arrange fundings to ensure quicker and more efficient disaster responses, also drawing on public private partnerships.

To enable financial institutions in supporting the transition, a consistent sustainable framework, and the coordination of relevant tools is needed, including the following areas:

1. **Taxonomy and transition pathways**
2. **Standardised reporting obligations**
3. **Sustainability in prudential regulation.**

1. The EU Taxonomy and transition pathways

The Taxonomy is an important first step to make environmental impacts measurable and create transparency. It provides a good, present-day scientific understanding of where we should be heading to and is thus a valuable navigation tool for target setting and tracking. However, from an investor's point of view, the assessment of companies is not only about the current level of environmental performance and the future goal to reach climate neutrality by 2050, but about the journey in between. In order to reach a broad transition of the economy, financing credible transformation pathways of companies is critical.

Extending taxonomies beyond green activities to those which may be relevant for transition will be important to ensure they support short-term planning as well as long-term strategies for meeting 2050 targets.

The envisaged Taxonomy extension introducing "intermediate performance" (IP), has the potential to 1. mitigate the current binary character of the Taxonomy by providing an additional nuance to the environmental impact of activities; 2. create more transparency on actual environmental performance levels of companies; 3. shed more light on the dynamic nature of the transition process by acknowledging already existing transformation efforts on companies' paths to improving their sustainability performance; and 4. create a stronger incentive to transform away from "significant harm" (SH) activities towards more sustainability. However, SH activities with a robust transition plan should not be stigmatised and transition financing of the respective corporates should not be undermined.

The Taxonomy is still in the development phase. With 1. increased availability of data; 2. the coverage of more activities; 3. the envisaged taxonomy extensions; and 4. clear policy signals to the real economy sectors that they need to transition (Fit for 55 package), the desired effects of reorienting capital flows towards the transition to a sustainable economy may be reached. In general, the extension of the Taxonomy should not render the framework disproportionately complex and overly burdensome given that usability of the Taxonomy is crucial to upscale sustainable finance. From an investor's perspective the Taxonomy represents only one instrument for a company's sustainability assessment that factors into an overarching evaluation of transition readiness and progress. It is important to engage with companies to understand their overall governance and strategies, constraints and opportunities, and how they plan to ultimately achieve the Net-Zero transition.

EFR Recommendations :

- The taxonomy should be extended to reflect different levels of environmental impact. This will allow us to better capture the dynamics of the transition and to set stronger incentives to improve companies' environmental performance. All activities that have a transition potential on the basis of a robust, science-based, measurable transition plan, should be transparently indicated as such given that, especially for those activities, financing is needed.
- A better recognition of the decarbonisation efforts of corporates with credible and robust transition plans is the prerequisite to ensure a global and inclusive transformation of the economy.
- The taxonomy can only serve as a reliable guidance for companies, governments and investors if the criteria are not changed too frequently. Forward-looking transparency about the expected future review of the criteria needs to be provided by the Platform on Sustainable Finance/the European Commission as a minimum.

2. Developing global sustainability reporting standards

Europe is at the forefront in the development of the ESG policy agenda and this fall two European countries, the UK and Italy, will be hosting respectively the COP26 and the G20, at a time when global ESG momentum has been accelerating among public authorities, financial institutions, non-financial corporates and civil society at large. The EU CSRD (Corporate Sustainability Reporting Directive) initiative will improve the availability and quality of sustainability data. However, a high degree of comparability can only be achieved via global convergence. Globally harmonised standards must be developed urgently to achieve the necessary transition to a net-zero planet. These should leverage on the considerable work that has already been carried out by organisations such as the FSB TCFD, the Network for Greening the Financial System (NGFS), the International Platform on Sustainable Finance (IPSF) and some jurisdictions.

<u>Shifting from voluntary to mandatory disclosure</u>

Disclosure of ESG data by all large (both listed and non-listed) corporates in all jurisdictions provides an incentive to accelerate the transition. Disclosures provide transparency to investors who are increasingly keen to understand and monitor the sustainability impact of their investments.

The availability of reliable ESG data through harmonised, ideally global standards is key to channel funding to both green and transitional activities. At the same time, establishing a framework that guarantees the high quality, reliability and accessibility of such data is essential to enable implementation while leveraging digital platforms as much as possible.

The EFR therefore recognises the recent statements of G7 and G20 leaders expressing support to the development of mandatory global reporting standards, building upon the TCFD framework and the work of sustainability standard-setters and hope that further steps will be made in the run-up to COP26. The EFR is cognizant, however, that moving from voluntary to mandatory disclosures creates challenges in a context where ESG data is scarce and, even when available, its quality is not based on robust and comparable definitions across jurisdictions. Hence, in a first stage, the move from voluntary to mandatory reporting requirements would be most effective if based on already existing and accepted standards such as the FSB TCFD.

Proportionality needs to be applied. The EFR supports the EC CSRD proposal that non listed SMEs should be exempted from mandatory disclosure while offering the possibility to "opt in" based on an appropriately reduced framework. In any case, the entity scope and resulting corporate data availability should be reflected in financial institutions' reporting requirements.

Which ESG-related metrics?

ESG disclosures cannot be limited to qualitative aspects given that the monitoring of progress towards alignment with the Paris Agreement requires measurable quantitative KPIs. This is well recognised by the European Commission's approach for the new disclosures under Article 8 of the EU Taxonomy Regulation.

While ESG transition pathways are necessarily specific to each sector/country, disclosure frameworks should include core KPIs that are common across sectors and jurisdictions. Investors will need to be able to aggregate those common KPIs to monitor and disclose their own ESG performance.

The concept of a Green Asset Ratio (GAR), i.e. the proportion of underlying activities/investments that are "green" as currently defined under the EU environmental taxonomy, is likely to also emerge as a key concept for ESG disclosure at global level. GAR should also be complemented with other KPIs that reflect the transition efforts of financial institutions and their clients in transitioning towards clean activities. At the same time, it will be important for the EU's GAR to ensure that it captures non-EU "green" activities both in the numerator and the denominator and such a symmetrical approach should also be the basis of any GAR adopted internationally.

Carbon Markets

We observe increasing investor appetite for directing capital towards a low-carbon and sustainable future[1]. However, in the absence of consistent data, financial markets cannot fully price climate related risks and opportunities and thus may not realise the full potential of products to support the transition.

The most efficient tool to move forward would be clear, globally applicable market incentives, such as a carbon price. While the EU's emission trading system currently only covers economic sectors that account for less than 50% of total carbon emissions, the envisaged expansion under the Fit for 55 package is highly welcomed.

EFR Recommendations :

- Develop mandatory global ESG disclosure standards for corporates with core KPIs that are common across sectors and jurisdictions, responding to growing investor expectations, allowing comparability and fostering global ESG capital flows. The IFRS Foundation work on developing climate-related reporting standards based on TCFD recommendations should be articulated properly with existing regional initiatives, such as in the EU, completed quickly to encompass as early as possible other sustainability dimensions and adopted globally. Consistent reporting standards with reliable and comparable data can only be generated when mandatory reporting is applied in all sectors of the economy.
- The adoption of the double materiality principle allows to have a view on how companies reach sustainability goals while providing a more complete view of companies' context, including their risks and opportunities, helping them and their stakeholders to have a more comprehensive and long-term view of their activities. Hence, it should be considered how to best integrate the concept of double materiality in the sustainability reporting standards, taking into account the practical complexities of the inside-out impact perspective.
- Enhance articulation and synchronisation between EU and non-EU initiatives to support international convergence. While recognising that the EU has taken significant steps to develop a robust set of sustainability reporting standards, it should contribute and work towards a global common approach to achieve a high degree of data comparability. EFRAG (European Financial Reporting Advisory Group) and ISSB (International Sustainability Standards Board) should be appropriately involved to co-create a global baseline of international convergent standards.
- It will be critical to ensure an appropriate scope of EU sustainability reporting such that EU standards do not imply competitive distortion between EU financial institutions and non-EU financial institutions while taking into account the specific challenges and difficulties that both EU and non-EU headquartered financial institutions will face to report information on their operations in third countries where companies will not be subject in the short/medium term to (equivalent) sustainability disclosure requirements – including on Taxonomy alignment - as companies domiciled in the EU.
- Consistency between the scope, the timeline and content of corporate disclosure standards and financial sectors disclosure requirements is critical to (i) adequately price climate related risks and opportunities, (ii) further develop carbon markets and (iii) enable financial sector compliance, conditioned upon the availability and reliability of corporate ESG disclosures, hence the need for a delay between corporate ESG disclosures and financial sector disclosures.

3. Sustainability considerations in prudential regulation

The financial sector prudential regimes, developed over decades, are risk-based and are aimed at firms adequately managing risk and maintaining financial stability. While there seems to be growing momentum behind incorporating climate change considerations into prudential standards, it is of utmost importance that prudential regulation remains

[1] See work by the Institute of International Finance (IIF) Taskforce on Scaling Voluntary Carbon Markets

risk-based. We support a risk management approach that includes climate and environmental risks, while mitigating climate change through an economy-wide transformation to net zero, and with cautious use of the prudential regime as an instrument to achieve this.

We value the steps taken by regulatory and supervisory bodies in relation to climate risk, in particular in the EU, which has been at the forefront of developing climate risk expertise in the financial sector in an innovative and collaborative way. We should continue to work jointly to increase climate and environmental risk capacity across the financial sector globally.

Climate and environmental risks pose significant challenges to evaluate given long-term horizons, and climate uncertainties[2]. Forward-looking assessment remains experimental research, rather than business-as-usual.

The results of the first climate risk exploratory exercises have shown modest financial impacts of climate change related risks to date, illustrated by the pioneering DNB[3] efforts in 2018 as well as more recent ACPR[4] results in 2021. The ECB and ESRB work has also shown financial impacts that are lower than those that occur in the core financial stress tests. All have understood these as initial learning exercises. Thus, we should be cautious about adjusting prudential regime calculations in the absence of clear and comprehensive data as to what risks need to be accounted for and how they should be treated.

The insurance prudential regime, Solvency II, has already been amended to reflect climate risks in risk management, governance and companies' ORSAs. More work is coming in the area of prudential treatment of exposures related to assets and activities associated with environmental and/or social objectives[5].

To conclude, there is a need for mutually supportive policy frameworks across financial and real economy sectors that allow for more evidence to emerge that could inform future prudential frameworks. Thus, we welcome the Fit for 55 package and are committed to supporting our clients through that transformation. This will allow firms to prioritise resources and support clients through transitions.

EFR Recommendations :

- A prevailing objective is to make carbon-emitting sectors greener to ensure the competitiveness of the EU economy and an inclusive transition.
- Prudential regimes should not be considered a first line of defence and should not deviate from their role of safeguarding financial stability and the resilience of the financial sector. Risk differentiation analysis should be a prerequisite for considering amendments to prudential frameworks.
- After completion of the ECB climate stress test in 2022, European authorities should take stock of lessons learned. This should include outreach to supervisors in other countries with major financial centres that have completed tests (e.g. UK, Switzerland, Japan, Hong Kong, Singapore). Discussion should occur through NGFS and the Basel Committee Task Force on Climate-related Financial Risks (TFCR) to arrive at a consensus view on the way forward internationally on the prudential framework's three pillars.
- Work in the prudential area should focus on enhancing the risk-based nature of frameworks and addressing existing disincentives to sustainable investment. This, combined with the parallel EU work on disclosures/carbon tax/Fit for 55 initiatives will allow the financial sector to play its full role in key political objectives such as investment, economic recovery and funding the transition to a net-zero economy.

[2] It is noted that the last IPCC report and IEA scenario have already shown that there are uncertainties in terms of impacts of the warming path we are on, what needs to be adapted and what needs to be stopped

[3] De Nederlandsche Bank

[4] Autorité de contrôle prudentiel et de résolution

[5] See proposals by the European Commission on the Solvency II review of 22 September 2021

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