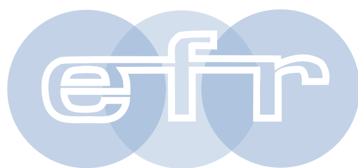

European Financial Services
Round Table

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EFR PAPER ON SUSTAINABLE FINANCE : THE CASE FOR A SIMPLER REGULATORY FRAMEWORK

The transition to Net Zero is one of the major challenges facing the European economy. The EU Commission estimates that €480bn of additional investment per year is required over this decade to meet the 2030 emission reduction target[1].

A major increase in European investments in the ecological transition is therefore needed on account of the present level of investment being far too low to reach the Net Zero goals. This is the main challenge for Europe.

The European financial services sector is a core enabler of that transition and stands ready to provide the support needed to clients. However, as net zero sustainability policy develops, it is important that there is certainty for both firms and investors, and that the financial stability implications of climate change and environmental degradation, as well as their social stability implications without a just transition, are managed in a risk-sensitive manner. The overall approach should accommodate the general principle that the transition must be financed, given that a funding gap might prove to be one of the main challenges, while also ensuring that the policy framework supports growth and competitiveness of businesses.

Over the last decade, sustainable finance has become a core focus for regulators and now affects every activity of a company. However, policy development has taken place at varying speeds in different jurisdictions, leading to a patchwork of requirements that have preceded the development of global standards (many of which are still under development or are to be developed). The EFR believes that regulatory fragmentation should be avoided and that requirements which meet a baseline standard, whilst unlikely to be fully aligned, should be interoperable to avoid placing excessive and duplicative compliance burdens on firms.

Banks and insurers continue to improve their management of climate-related financial risks, although challenges remain with both data availability and scenario analysis. It is important for the financial and official sectors to work together to share best practices and identify areas for further improvement. This is particularly the case, given that the EFRAG and ISSB standards allow in-scope entities not to disclose datapoints if they are not material to that entity. Although this is a reasonable approach, it does require the adoption of a robust and common materiality assessment to avoid perpetuating data challenges, particularly in the SME sector, something that banks and insurers cannot solve by themselves.

Regulation should support investment in the transition

The European financial services sector is a key catalyst of the transition to Net Zero. As we approach the tenth anniversary of the Paris Agreement, it is important to take stock of the various and sometimes overlapping areas of regulation that have emerged to ensure they support and do not hinder investment. It is also important to identify possible areas where simplification or refinement may be required to facilitate the achievement of 2030 and 2050 goals.

The regulatory framework needs to be coherent and constructed in such a way that it allows financial services to contribute to funding the transition to a net zero economy, rather than imposing a significant compliance burden to the extent that it constrains investment and creates confusion amongst investors. Regulators should acknowledge that climate and ESG remain developing areas of expertise, and should consider using a mix of rules, principles and guidance to allow best practice to develop within the market, rather than adopting an overly prescriptive approach which does not allow for progress and innovation over time.

[1] The EC "Strategy for Financing the Transition to a Sustainable Economy" 6.7.2021.

Case Study: EU Corporate Sustainability Due Diligence Directive

The Corporate Sustainability Due Diligence (CSDDD) proposal, which is currently being negotiated by EU institutions, requires businesses, including the financial services sector, to identify, prevent, and/or mitigate adverse environmental and social impacts of their activities, as well as of the operations of their value chains. While the financial sector supports this initiative, it is important for the CSDDD to be proportionate, based on a risk-based approach and as workable as possible, preserving the competitiveness of the EU financial sector. It should, as far as possible, be aligned with existing, robust due diligence expectations for financial institutions, and mitigate the legal and implementation risks faced by financial institutions, whose clients would already be directly affected by the Directive.

Global standards are still emerging, but interoperability is key

Corporate sustainability reporting is an essential part of the sustainable finance regulatory framework, as it provides information to support investor decision-making and allows financial services firms to better understand the physical and transition risks to which they are exposed. It is inevitable that different regulators will take different approaches to implementing and enforcing the global baseline recently developed by the International Sustainability Standards Board (ISSB), which – without any form of interoperability – poses challenges to the strategic objectives of global standard setters, creates additional costs of doing business for firms operating in multiple jurisdictions, and makes it challenging for investors to effectively factor in sustainability disclosures. In that context, we welcome the efforts by EFRAG and ISSB towards reaching this interoperability of the frameworks, and we encourage them to continue working together as the development of the sustainable reporting framework evolves.

Against the backdrop of an urgent climate threat, geopolitical volatility, energy price inflation and energy security concerns, there is now, more than ever, a once-in-a-generation opportunity to adopt a globally consistent baseline of sustainability disclosures. Challenges still exist regarding the level of maturity of sustainability reporting in some areas of the global economy, and the associated availability and quality of data resulting from this. In light of this, scalable, proportionate and phased implementation is needed to balance the need for progress, given the practical challenges posed by the transitionary period as these standards are implemented and adopted globally. In particular, the higher expectations placed by investors and supervisors on disclosure of banks' and insurance companies' transition plans demand further work to facilitate adoption of common metrics across jurisdictions.

Case Study: ISSB and ESRS disclosures

The EFR supports alignment of core aspects of European Sustainability Reporting Standards (ESRS) and the ISSB Standards, including on central concepts such as value chain and materiality. To that end, the EFR welcomes the work being undertaken by EFRAG on the publication of a preliminary interoperability table[2] that can be relied upon by preparers to navigate the application of the ISSB Standards and ESRS. It is necessary for such a table to be published in a timely manner to enable preparers to rely on this table when preparing to report in accordance with these standards. We also recommend that the final table should be published as a joint effort of the EU authorities and the ISSB to ensure there is a common final understanding concerning interoperability.

Where concerns over interoperability remain – at this stage largely relating to various climate-related aspects (including the definition of carbon credits and reporting related to financed emissions), we would urge policymakers to keep these aspects under review pending final assessment.

Divergent standards will also lead to different requirements and definitions of what is green and what is not, meaning that some products might meet the definition in one market and not in another. This complex but still incomplete framework is leading not only to implementation challenges but also to an increasing risk of greenwashing, translating into reputational impacts for firms.

Policymakers should consider the ways in which the sustainable finance regulatory framework could be made simpler, clearer and more consistent in order to avoid disincentivising companies from moving towards decarbonised business models and prevent the risk of greenwashing. In the same vein, it is worth noting that the reliability of the data also depends on the credibility of ESG data providers as they will continue to play a role before and after the implementation of CSRD (e.g for the companies outside CSRD). In this regard, the regulation and supervision of this sector would be critical to ensure data quality.

Separately, supervisors should consider the ways in which their approaches to the oversight of climate-related financial risks and associated stress testing have evolved over time. The EFR would support an approach that promotes regulatory cooperation to share best practice and reduce fragmentation for firms operating in multiple jurisdictions.

[2] EFRAG paper on Interoperability between ESRS and ISSB standards

Investment in transition activity is as important as "bright green"

To date, the regulatory framework has focused on identifying those sectors whose activities are already deemed to be sustainable. This narrow focus, only now being supplemented by emerging guidance on transition finance, risks channelling finance only to those activities and products that are already on a sustainable path while diverting capital away from the transition itself and potentially raising the capital cost of financing the transition. The G20 has noted[3] this trend: despite the rapid growth of green and sustainable finance markets, support for the broader range of investments needed to enable climate transition for the overall economy, including GHG-intensive sectors and firms, has been limited.

Policymakers should also bear in mind that the transition to net zero is a global challenge – particularly in developing economies – and there is merit in financing activities which provide incremental benefits whilst not yet meeting European sustainability standards. Such considerations should be factored in by the new EU Platform on Sustainable Finance and by the European Commission.

The EU taxonomy is the cornerstone of European ESG-related regulation. As such, it should be seen as a valuable tool for the assessment of environmentally sustainable finance reporting is an essential part of the regulatory framework, since it provides transparency to investors and allows financial services firms to better understand the physical and transition risk drivers to which they are exposed.

Currently, the Taxonomy is helpful in providing a consistent definition of what is considered sustainable. However, the EU taxonomy currently covers only about 40% of the economic activities of EU companies, as the taxonomy targets activities with the highest emissions.

European regulators should also focus on establishing a transition finance framework, with principle-based guidelines and benchmark sectoral transition pathways and company-specific transition plans, based on existing initiatives such as GFANZ. Moreover, a consistent framework for transition planning requirements should be ensured in the EU and internationally, including across the disclosure-related standards set by EFRAG and ISSB. To that extent, the EFR welcomes the European Commission's June 2023 Recommendation on Transition Finance, which illustrates ways in which voluntary use of various aspects of the EU sustainable finance framework (including the Taxonomy, Green Bond Standards and climate benchmarks) can support transition finance.

However, as justifiably noted by the Platform of Sustainable Finance itself, European regulators should carefully consider the trade-offs at hand, particularly the higher level of complexity of an extended Taxonomy framework for all stakeholders and the costs of additional reporting obligations, and do so while the original Taxonomy is just starting to be used and before the impact of its use can be formally assessed.

Case Study: Taxonomies and alternatives

Since banks' green asset ratios, as currently defined under the Taxonomy Regulation, offer no insights into how the financial sector is helping to finance the transition, the EU regulators should take into account learnings from other geographies, which are developing broader and more dynamic approaches than that currently proposed under the EU Taxonomy.

The Swiss Climate Scores launched by the Swiss Federal Council in 2022 are aimed at providing institutional and private investors in Switzerland with comparable and meaningful information on the extent to which their financial investments are compatible with international climate goals. While they are currently in a pilot phase and application is voluntary, the Federal Council recommends that Swiss financial market players apply the Swiss Climate Scores to financial investments and client portfolios where appropriate. To ensure that the Swiss Climate Scores continue to represent best practice in terms of climate transparency in the future, they will be reviewed on a regular basis and adapted to latest international findings as needed, starting in 2023.

Separately, research by the UK's Green Technical Advisory Group[4] has found that, notwithstanding significant market support for the concept, a number of the Do No Significant Harm (DNSH) criteria are inconsistent, overly repetitive, difficult to measure and understand due to ambiguity in drafting, in addition to more fundamental issues with the concept of 'significant harm'. It has set out recommendations for how the EU's DNSH criteria can be improved while also promoting harmonisation of various green taxonomies globally.

Singapore's "traffic light" system includes a transition category, which allows for a dynamic rather than granular and static framework, which can reflect the data available at any given point in time.

[3] 2022 G20 Sustainable Finance Report of the Sustainable Finance Working Group, June 2022 (page 4)

[4] greenfinanceinstitute.co.uk/wp-content/uploads/2023/08/GTAG-Final-Report-on-DNSH.pdf

The prudential framework for climate-related factors should remain risk-based

Climate change should continue to be seen as a driver of traditional financial risks, including credit, operational and market risks. Given the objective of supporting the transition, the EFR is concerned that politicising capital requirements could jeopardise the transition of the global economy and affect the competitiveness of European companies. Regulatory authorities in the EU and UK have begun to consider the ways in which these types of risks could be integrated into the prudential framework[5], noting that any such treatment needs to address the effects, rather than causes, of climate change. However, capability, current divergent views and framework gaps make this challenging to achieve in the near term. The key gaps are i) lack of robust climate-related data, ii) lack of consistent risk modelling methodology, and iii) the need for international consensus ahead of any potential change to capital treatment.

The other challenging aspect is the inclusion of transition plans of EU credit institutions in the scope of the prudential supervision, taking account of EU Climate law. This is particularly important given that, in contrast to the longer-term 2050 objective of carbon neutrality, the 2030 transitional objective enshrined in EU legislation lacks sectoral pathways and scenarios, making it challenging to incorporate into financial institutions' own transition plans. Any extension of prudential supervision to include financial institutions' transition plans should also be consistent with the risk-based nature of the prudential framework.

As data becomes more readily available, financial institutions may be better able to integrate climate-related factors in their existing risk categories and models (for example, revising Loss Given Default estimates for a property portfolio with high exposure to flood risk, increasing the risk-weighting as a result). Over time, it may therefore be possible to consider how different prudential tools can best respond to climate change-related financial risks, without applying blunt and risk-insensitive supporting or penalising factors for green or brown exposures.

There is a growing consensus amongst certain regulators that adjustments to the Pillar 1 framework are not warranted and should not be pursued at present, while Pillar 2 measures could be considered. It is imperative that any changes should be guided by international financial standard-setting bodies to ensure a consistent approach and level playing field across jurisdictions.

[5] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/report-on-climate-related-risks-and-the-regulatory-capital-frameworks; eiopa.europa.eu/system/files/2022-12/discussion_paper_on_the_prudential_treatment_of_sustainability_risks.pdf & c

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