



Sustainable finance and the EU regulatory framework

An overview

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Sustainable development

Sustainable development

What is sustainability?

- Sustainability in its core definition **goes much beyond** the financial investment universe
 - ***“sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs”*** – UN World Commission on Environment and Development
- *Sustainable development* means that current and future generations have the resources needed, such as food, water, healthcare and energy, without stressing the Earth system processes



Sustainable development Concept

- Sustainable development is an integrated concept with three aspects: economic, social and environmental.
 - **Environmental challenges:** climate change, land-use change, biodiversity, loss and depletion of natural resources
 - Poverty, hunger and lack of healthcare show that many people live below minimum social standards
 - **Our economic models** were developed in an empty world with an abundance of goods and services produced by nature

Sustainable development

2015 COP21 and 2030 Agenda

- Paris Agreement (COP21) of 2015, adopted by 196 countries, is the **first universal and legally binding agreement on a global action plan**
- To guide the transition towards a sustainable and inclusive economy, the United Nations has developed the **2030 Agenda for Sustainable Development** (UN, 2015); 17 high level goals are specified in 169 targets
- ***Global Strategy***
 - Government policy
 - Technological change

Sustainable development

UN Sustainable Development Goals (UN SDGs)

- *Overall goal*

- **Goal 17.** Strengthen the means of implementation and revitalise the **Global Partnership** for Sustainable Development

- **Economic goals**

- **Goal 8.** Promote sustained, inclusive and sustainable **economic growth**, full and productive employment and decent work for all
- **Goal 9.** Build **resilient infrastructure**, promote inclusive and sustainable industrialisation and foster innovation
- **Goal 10.** **Reduce inequality** within and among countries
- **Goal 12.** Ensure **sustainable consumption and production** patterns

Sustainable development

SDGs: Social goals

- **Goal 1. End poverty** in all its forms everywhere
- **Goal 2. End hunger**, achieve food security and improved nutrition and promote sustainable agriculture
- **Goal 3. Ensure healthy lives** and promote well-being for all at all ages
- **Goal 4. Ensure inclusive and equitable quality education** and promote lifelong learning opportunities for all
- **Goal 5. Achieve gender equality** and empower all women and girls
- **Goal 7. Ensure access to affordable, reliable, sustainable and modern energy** for all
- **Goal 11. Make cities** and human settlements inclusive, safe, resilient and sustainable
- **Goal 16. Promote peaceful and inclusive societies** for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels

Sustainable development

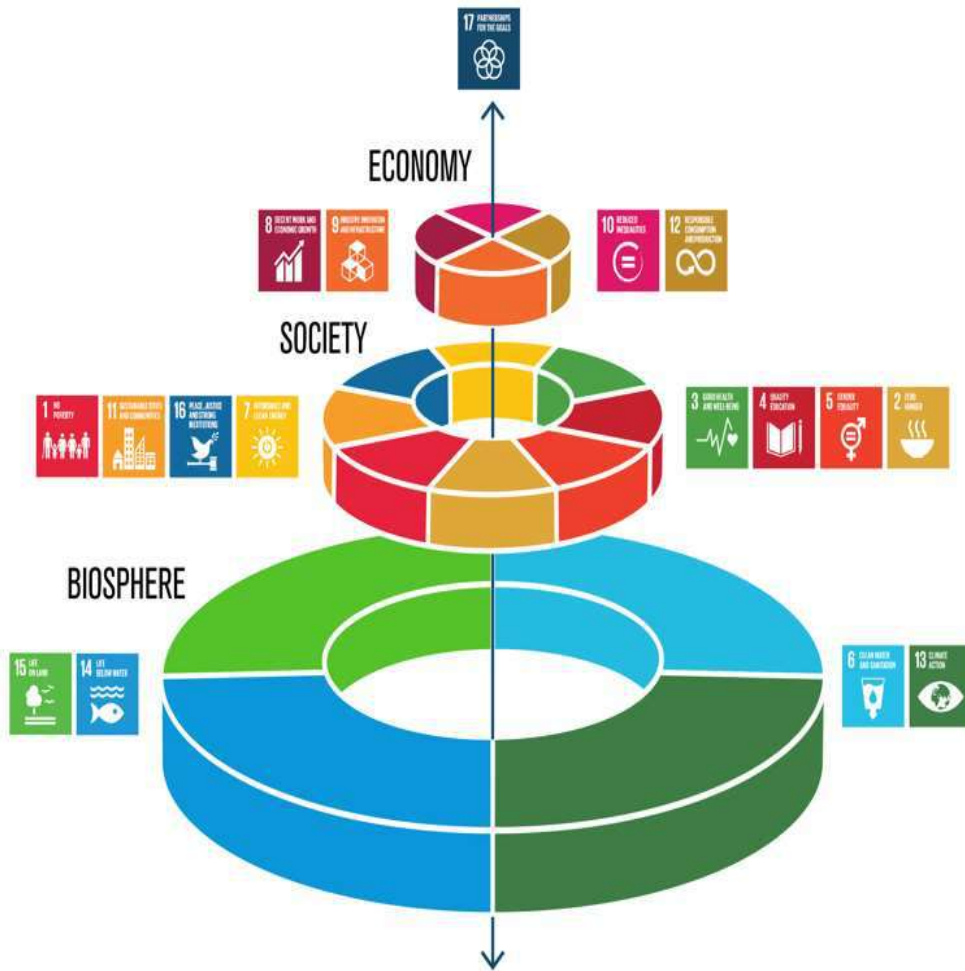
Sustainable Development Goals

- **Environmental goals**

- **Goal 6.** Ensure availability and sustainable management of **water** and sanitation for all
- **Goal 13.** Take urgent action to **combat climate change** and its impacts
- **Goal 14.** Conserve and sustainably **use the oceans, seas and marine resources** for sustainable development
- **Goal 15.** Protect, restore and promote **sustainable use of terrestrial ecosystems**, sustainably manage forests, combat desertification, halt and reverse land degradation and halt biodiversity loss

Sustainable development

Sustainable Development Challenges



- ✓ **Precondition:** a liveable planet
- ✓ Cohesive and inclusive society
- ✓ Organise production and consumption
- ✓ No specific relevance to the financial system
- ✓ Reference to investment as driver of sustainable development

The role of sustainable finance

What is sustainable finance?

Definition (EC)

- **Sustainable finance generally refers to the process of taking due account of environmental, social and governance (ESG) considerations when making investment decisions in the financial sector, leading to increased longer-term investments into sustainable economic activities and projects.**
 - **Environmental considerations** may refer to climate change mitigation and adaptation, as well as the environment more broadly, such as the preservation of biodiversity, pollution prevention and circular economy
 - **Social considerations** may refer to issues of inequality, inclusiveness, labour relations, investment in human capital and communities, as well as human rights issues
 - The **governance** of public and private institutions, including management structures, employee relations and executive remuneration, plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process

What is sustainable finance?

ESG factors

- Interdependence sustainability and ESG factors
- Key issue: what is under the umbrella of the ESG factors – **single definition still lacking**. According to a recent survey (EBA, 2021)
 - 11 international frameworks addressing ESG factors (from the UN SDGs to the Principles for Responsible Investments – PRI)
 - 6 frameworks specifically addressing environmental factors (recommendations of the Financial Stability Board TF on climate-related financial disclosures; Climate Bond Initiative on bond standards)
 - 10 frameworks specifically addressing social factors (including ILO principles)
- Relevance of these factors related to the so-called **financial materiality**: i.e., their potential material impact on the financial profile and/or risk profile of companies
- Interrelationship among the three factors

Sustainable finance

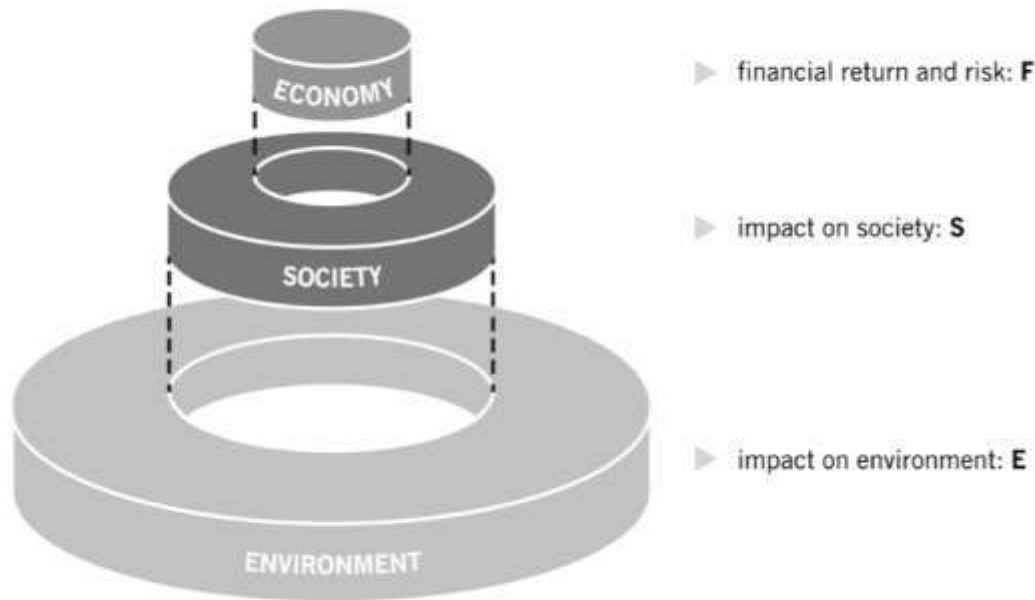
The role of finance

- Levine (2005) lists the following functions of the financial system:
 - **Produce information ex ante** about possible investments and **allocate capital**;
 - **Monitor investments** and exert corporate governance after providing finance;
 - **Facilitate** the trading, diversification, and management of risk;
 - Mobilise and pool savings;
 - Ease the exchange of goods and services.
- **Finance can play a role** by allocating funding to
 - its most productive use and in a sustainable manner
 - sustainable corporates and projects and thus accelerate the transition to a low carbon economy

Sustainable finance

Three stages of sustainable finance

Figure 1.5: Managing sustainable development



Source: Schoenmaker (2017).

- **Economy:** financial return and risk trade-off is optimised.
- **Society:** impact of business and financial decisions on the society is optimised
- **Environment:** environmental impact optimised

Sustainable finance

Framework for sustainable finance

Table 1.3: Framework for Sustainable Finance

Sustainable Finance Typology	Value created	Ranking of factors	Optimisation	Horizon
Finance-as-usual	Shareholder value	F	Max F	Short term
Sustainable Finance 1.0	Refined shareholder value	$F \gg S \text{ and } E$	Max F subject to S and E	Short term
Sustainable Finance 2.0	Stakeholder value (triple bottom line)	$I = F + S + E$	Optimise I	Medium term
Sustainable Finance 3.0	Common good value	$S \text{ and } E > F$	Optimise S and E subject to F	Long term

Note: F = financial value; S = social impact; E = environmental impact; I = integrated value. At Sustainable Finance 1.0, the maximisation of F is subject to minor S and E constraints.

Source: Schoenmaker (2017).

- From shareholder value to stakeholder value

Sustainable finance

Externalities - Internalisation



- **Problem:** Externalities are not reflected in prices
- **Why integrate ESG Factors?**
 - Anticipation of regulation / taxation (e.g. carbon tax)
 - Reputation – pressure from NGOs and consumers
 - Future-proof: transition to SDGs by 2030

Question: Who should act first? Government should tax and regulate vs all parties should act?

Sustainable finance

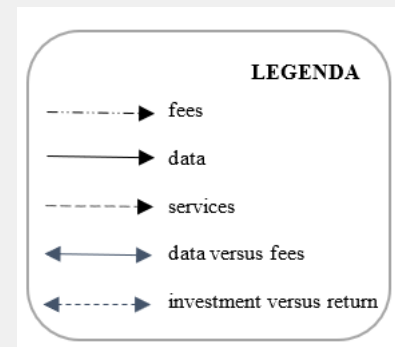
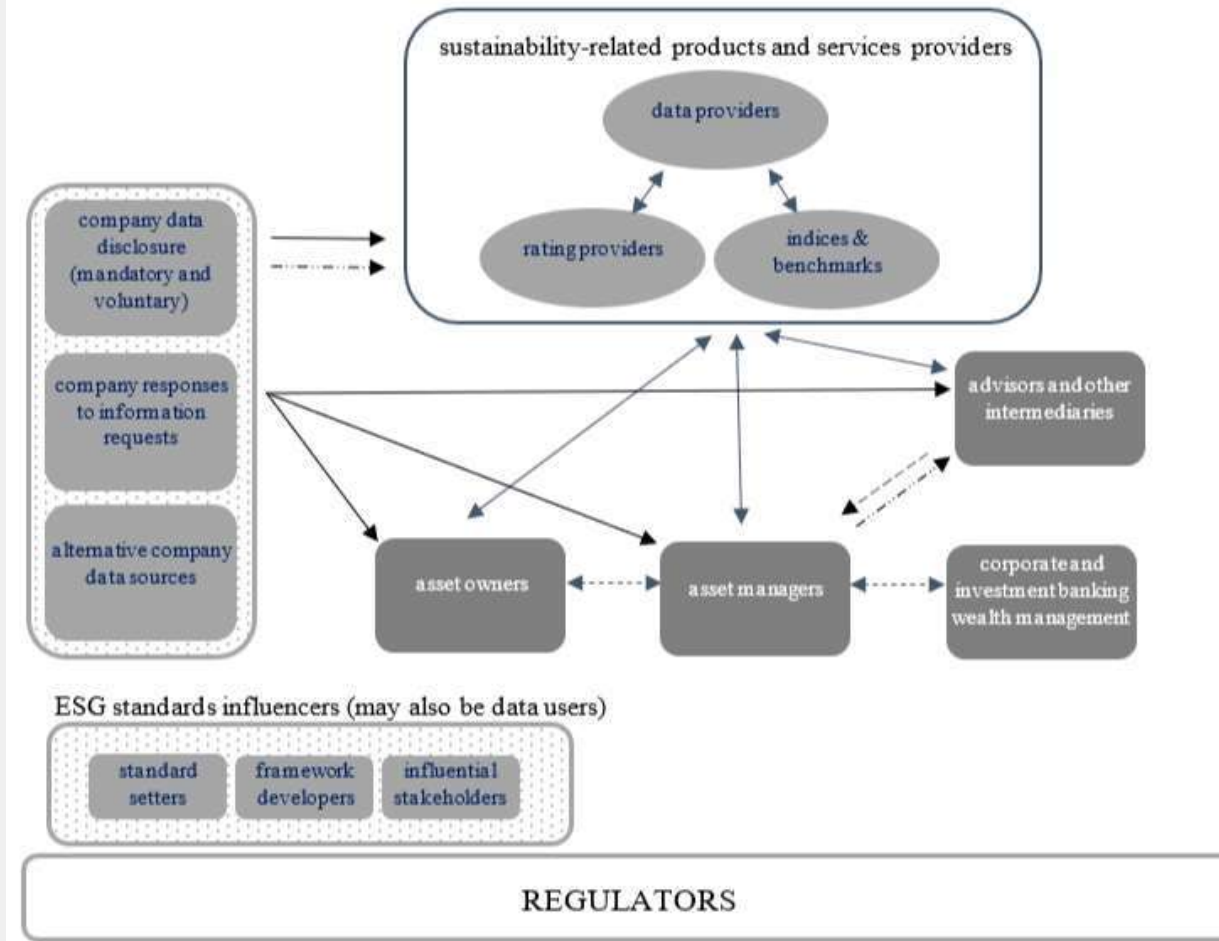
The ecosystem of sustainable information

- **Producers:** Companies are the main producers as they gather data and information on the:
 - ESG characteristics of their business
 - Sustainability of specific activities and projects
 - The ESG risks they are exposed to and the way to mitigate them
- **Disseminators:** ESG rating/scoring agencies
- **Users:** Investors are the main users of ESG information
- **Facilitators:** Bodies developing standards and frameworks contribute to enhance the reliability and comparability of the information disclosed by companies
- **Regulators and financial supervisors**

Sustainable finance

The ecosystem of sustainable information

Figure 3.1 The ecosystem of sustainable information



Climate risk

Climate risk Background

- Climate change driven by greenhouse gas emissions is a top issue on the policy agenda
- Can financial markets price the financial risk descending from climate change?
- Challenging issue as it refers to two categories of risks that could move in different directions: **Physical risk and Transition risk**

Definitions and conceptualisation

Understanding climate risks

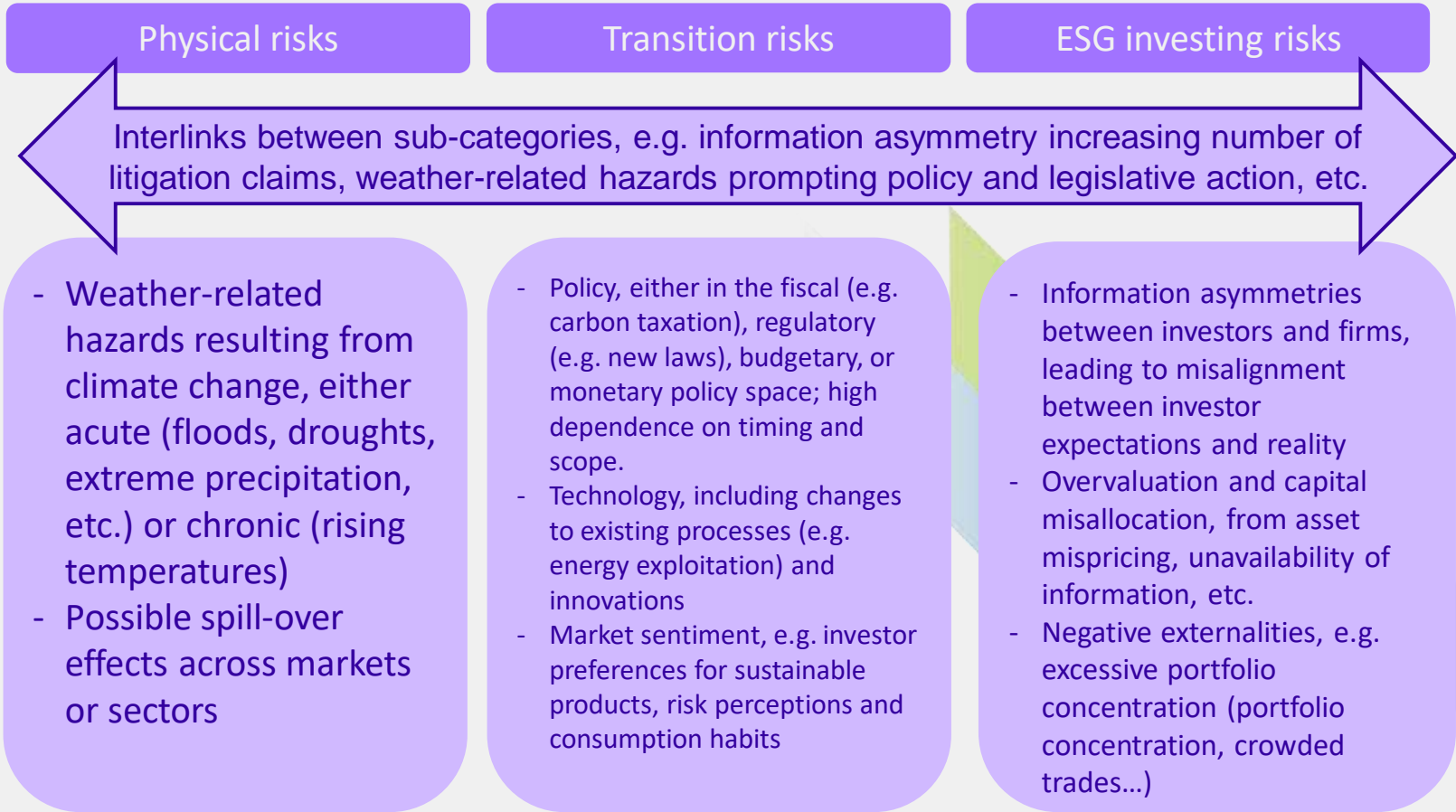
- *“Financial risks posed by the exposure of financial institutions to **physical or transition risks** caused by or related to climate change, for example, damage caused by extreme weather events or a decline in asset value in carbon-intensive sectors” (NGFS)*
- Physical risks arise from the physical effects of climate change and environmental degradation (e.g. weather-related hazards)
- Transition risks arise from the transition to a low-carbon economy through three main drivers: policy, technology and preferences
- These risks interact: physical risk can give rise to transition risk, while transition risk mitigation can help reduce physical risk

Main drivers of climate risks

Climate risks

Sub-Categories

Risk drivers



Sustainable finance

Climate risk assessment: Scenario Analysis

- **Policy uncertainty:**
 - **Timing:** when will labour laws be tightened and carbon taxes be introduced
 - **Reversal:** policies may be reversed / changed (e.g. solar panel subsidies)
- **Technological uncertainty**
 - Exponential growth: new innovations and spectacular rise of renewables (solar PV, wind)
 - Changes in consumer behaviour and preferences
- **Strategic approach to making scenarios**
 - **Determine most important uncertainties** for the future
 - **Elaborate the scenarios** with trends, uncertainties and possible actions
 - **Re-present scenarios** as potential paths in the future

Climate risks

Transition risks are the risks posed to the financial sector by a low-carbon transition

- **Policy risks:** Policies aiming at decreasing GHG emissions in order to not exceed the 2°C target by the end of the century, such as carbon prices, threaten the viability of carbon-intensive industries and related financial assets
- **Technology risks:** Beyond policy risks, there is uncertainty in technological development and deployment, which can represent both opportunities and risks for companies in exposed sectors. Technology trends may be amplified by policy incentives
- **Legal risks:** Legal risks may arise as a function of climate litigation, for example in the context of climate damages
- **Transition risks are characterized by their sectoral specificity and long-term nature.** Hence, while some subsectors might benefit from the transition (e.g. renewable energies, electric vehicles), or be left unaffected, some will be strongly hit (e.g. mining, ICE vehicles,...).

Climate risk

Physical risks are the risks posed by climate change's consequences

- Climate change's consequences include both **incremental effects** (long-term change in the mean and variability of climate patterns) and **acute effects** (i.e. increase in extreme weather events' frequency and/or intensity stemming from the incremental changes).

Table 2.1 Example of acute & incremental consequences of climate change

Incremental changes	Acute weather events
Changes in mean temperature	Tropical storms
Changes in rain falls patterns	Floods
Long-term changes in water availability	Heat & Cold waves
Sea-level rise	Droughts
Coastal erosion	Wildfires
Air quality degradation	Extreme snowfalls

- **Physical risks** are characterized by their geographical and sectoral specificity (the exposure to different hazards varies a lot among economic sectors and world regions), and their long-term horizon.

Climate risks

Why markets may fail in pricing climate risks

- **Lack of data/information:** Corporate disclosure and available information remain insufficient, incomplete and inconsistent
- **Short-termism:** Focus on short-term performance
- **Complexity and lack of rigorous analysis:** Methodological challenges
- **Markets do not even use the already available information.** Insufficient attention, data gaps, do agreed taxonomy at global level
- **Limited comparability of ESG ratings:** ESG ratings across five major providers only 60% correlated, compared with 99% for credit ratings from the largest CRAs

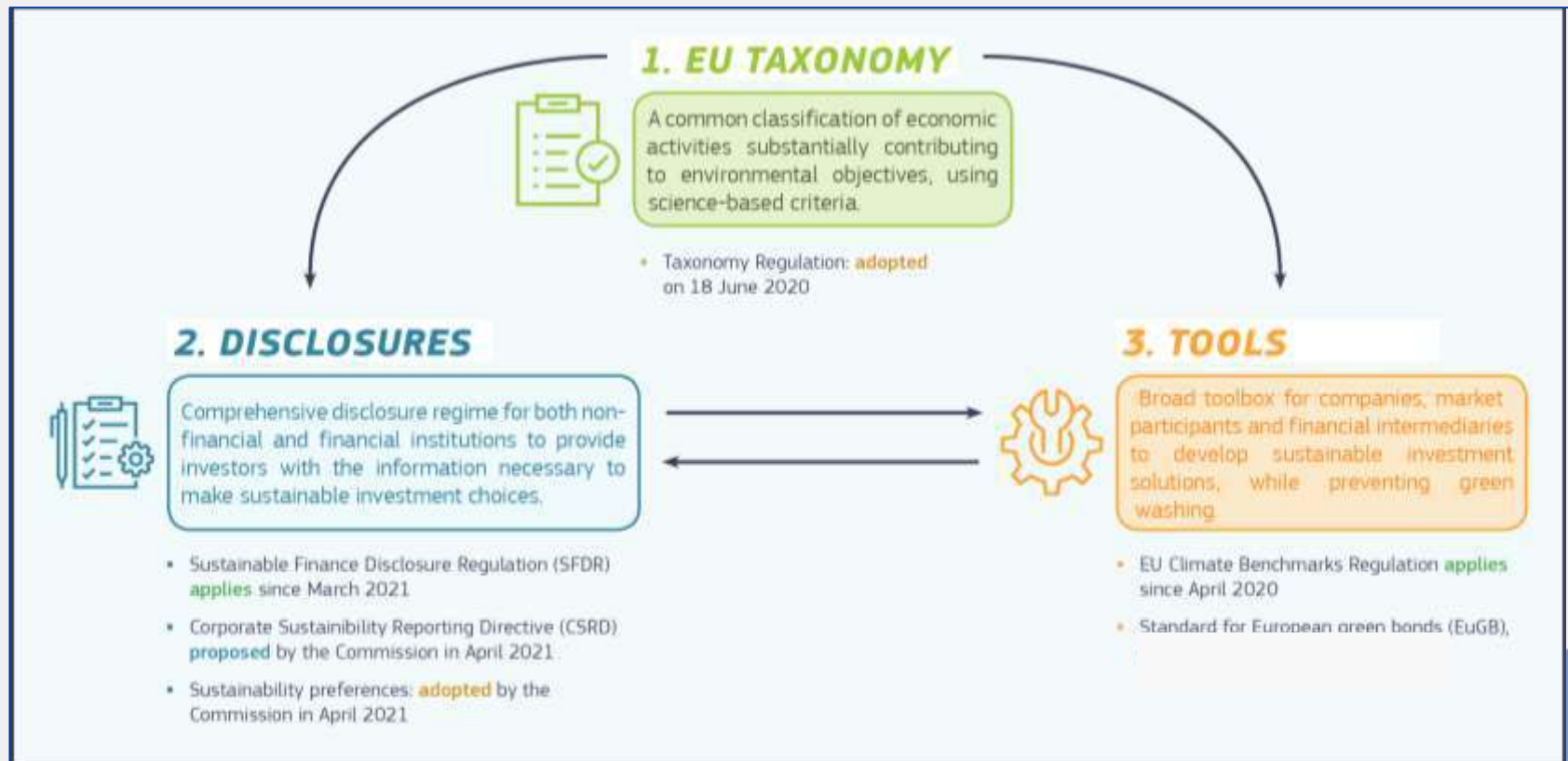
Climate risks

From Efficient Market Hypothesis (EMH) to Adaptive Market Hypothesis (AMH)

- **EMH:** claims that asset prices incorporate all the information relevant to investors
- **Critics:** Investors' irrational behaviour and the use of heuristics (Fama, 1998 and Kahneman, 2013) are the main explanation of the many anomalies of the EMH.
- **AMH:** (Schoenmaker and Schramade, 2020) the incorporation of ESG information into stock prices is an “adaptive” process, which would not be completed since not enough investors learn about the ESG risks on companies' risks and profits and take them into account in their investment choices

The EU Sustainable Framework: the big picture

Foundations of the EU sustainable finance framework



The European Green Deal announced a ‘Renewed Sustainable Finance Strategy’

- Complete the work started under the 2018 Action Plan on Financing Sustainable Growth
- An evolved context provides need for additional measures in four key areas



FINANCING THE TRANSITION TO SUSTAINABILITY

This strategy provides the tools and policies to enable economic actors across the economy to finance their transition plans and to reach climate and broader environmental goals, whatever their starting point.



INCLUSIVENESS

This strategy caters for the needs of, and provides opportunities to individuals and small and medium companies to have greater access to sustainable finance.



FINANCIAL SECTOR RESILIENCE AND CONTRIBUTION

This strategy sets out how the financial sector itself can contribute to meet Green Deal targets, while also becoming more resilient and combatting greenwashing.

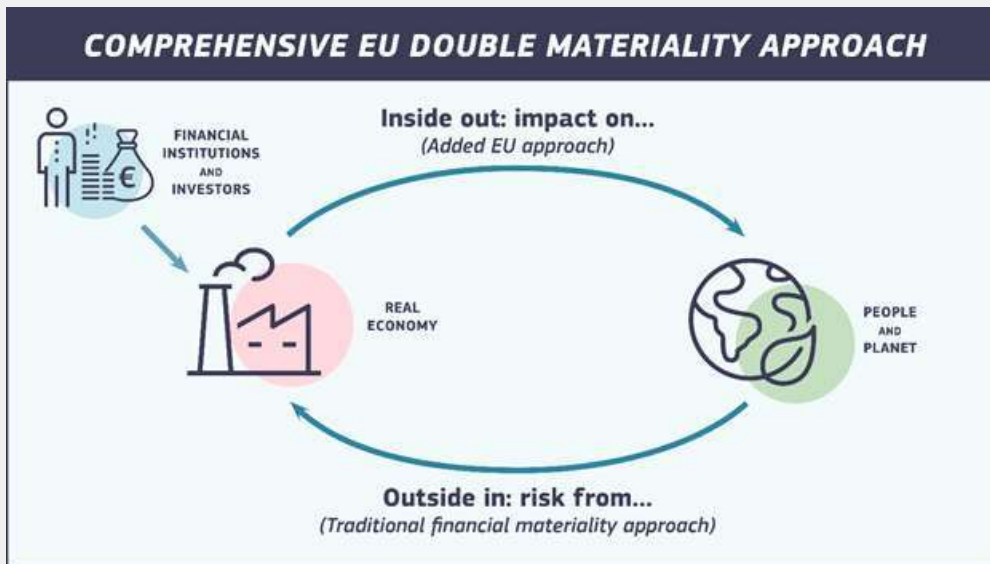


GLOBAL AMBITION

This strategy sets out how to promote an international consensus for an ambitious global sustainable finance agenda.



The EU double materiality approach



The **double materiality** approach consists of the systematic integration of both financially material sustainability risks (outside-in) and sustainability impacts (inside-out) in financial decision-making processes.

It is crucial that both angles of the materiality concept are duly integrated for the financial sector to contribute pro-actively and fully to the success of the European Green Deal.

Strengthening financial sector's resilience and contribution to sustainability



Enhance economic and financial resilience to sustainability risks

Reflect sustainability risks in **financial reporting standards and accounting**
Identify and managing sustainability risks by **banks and insurers**
Manage sustainability risks at **system level**

Increase the contribution of the financial sector to sustainability

Improve science-based target setting, disclosure and monitoring of the **financial sector's commitments**
Clarify the **fiduciary duties and stewardship rules** of investors to reflect sustainability impacts
Improve the availability, integrity and transparency of **ESG market research and ratings**

Monitor an orderly transition and ensure the integrity of the EU financial system

Monitor **greenwashing risks** and assess and review the current supervisory and enforcement toolkit to address green-washing
Monitor an **orderly transition of the EU financial system** and develop a robust **monitoring framework** to measure capital flows and assist Member States in assessing the investment gap

The EU Taxonomy

EU Taxonomy – defining sustainable



A classification system

Provides clarity on what is an environmentally sustainable activity and under which circumstances.



A measuring tool

Measures the degree of sustainability of an investment and the degree of green activities of companies



A transition tool

Helps investors and companies to plan and report on the transition. It sets the objectives and the direction of travel for different economic activities.

Ultimately, it helps raise the needed investments to build a net zero, resilient and environmentally sustainable economy.

What the EU Taxonomy is **not**:



- It's not a mandatory list to invest in
- It's not a rating of the “greenness” of companies
- It does not make any judgement on the financial performance of an investment
- What's not green is not necessarily brown.

Taxonomy – Objectives and Framework

Sustainability objectives

- (a) climate change mitigation,
- (b) climate change adaptation,
- (c) the sustainable use and protection of water and marine resources,
- (d) the transition to a circular economy,
- (e) pollution prevention and control, and
- (f) the protection and restoration of biodiversity and ecosystems.

Taxonomy framework



Make a positive contribution

(a) Substantial contribution
to at least one of the six
environmental objectives



Avoid significant harm

(b) Do no significant harm
to any of the other five
environmental objectives

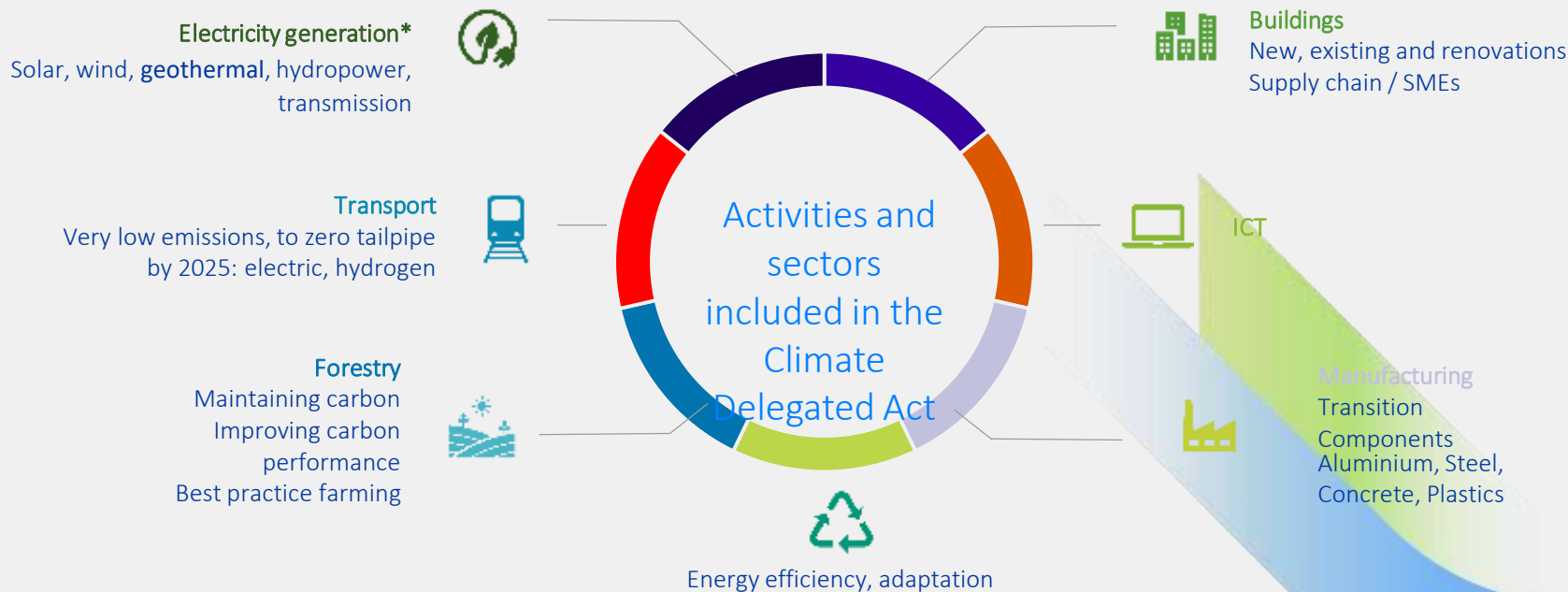


Social safeguards

(c) Comply with
**minimum
safeguards**

Climate Taxonomy - wide emissions and company coverage

First set of activities (Delegated act that covers climate change mitigation and adaptation objectives)



*Complemented in 2022 by certain gas and nuclear activities necessary for transition subject to strict conditions

EU Taxonomy – focus on impact

The EU Taxonomy aims to provide incentives to investors to finance transition projects.

By clearly defining what is in line with the EU Green Deal targets, the EU Taxonomy seeks to incentivise and encourage companies to launch new projects, or upgrade existing ones, to meet the EU Taxonomy criteria.

Examples of the most impactful areas – activities enabling transformation of the sectors with the highest contribution to CO2 emissions – **energy, manufacturing, buildings, transport:**

- **Renewable energies**
- **Manufacturing of hydrogen**
- **Batteries, storage of energy/hydrogen**
- **Heavy manufacturing**
- **Building renovations**
- **Low carbon transport**



Focus on usability, implementation and simplification

TAXONOMY - EU Taxonomy Navigator – A simple and practical guide for users

[EU Taxonomy Navigator \(europa.eu\)](https://europa.eu)

- **EU Taxonomy Compass** - a visual representation of sectors, activities and criteria included in EU Taxonomy
- **EU Taxonomy Calculator** – a step-by-step guide on reporting obligations
- **FAQ repository** – an overview of questions and answers on EU Taxonomy and its delegated acts

Taxonomy package (June 2023)

Amendments to
Climate Delegated Act
(entered into force on 1 January 2022)

Environmental Delegated Act
(incl. amendments to Disclosures Delegated Act)

Climate Change
Mitigation



Climate Change
Adaptation



Circular
Economy



Water and
Marine Resources



Pollution Prevention
and Control



Biodiversity and
Ecosystems



Sectors included in the draft Environmental DA



Sustainable use & protection of water & marine resources

- Manufacturing
- Water supply, sewerage, waste management and remediation activities
- Disaster risk management
- Information and communication



Transition to a circular economy

- Manufacturing
- Water supply, sewerage, waste management & remediation
- Construction & Civil engineering
- ICT
- Services



Pollution prevention and control

- Manufacturing
- Water supply, sewerage, waste management and remediation activities



Protection & restoration of biodiversity & ecosystems

- Environmental protection and restoration activities
- Accommodation activities

35 Activities

Sectors included in the Climate DA



Climate change mitigation

- Manufacturing
- Transport

17 activities



Climate change adaptation

- Water supply, sewerage, waste management & remediation
- Civil engineering
- ICT
- Professional, scientific and technical activities
- Disaster risk management

6 activities

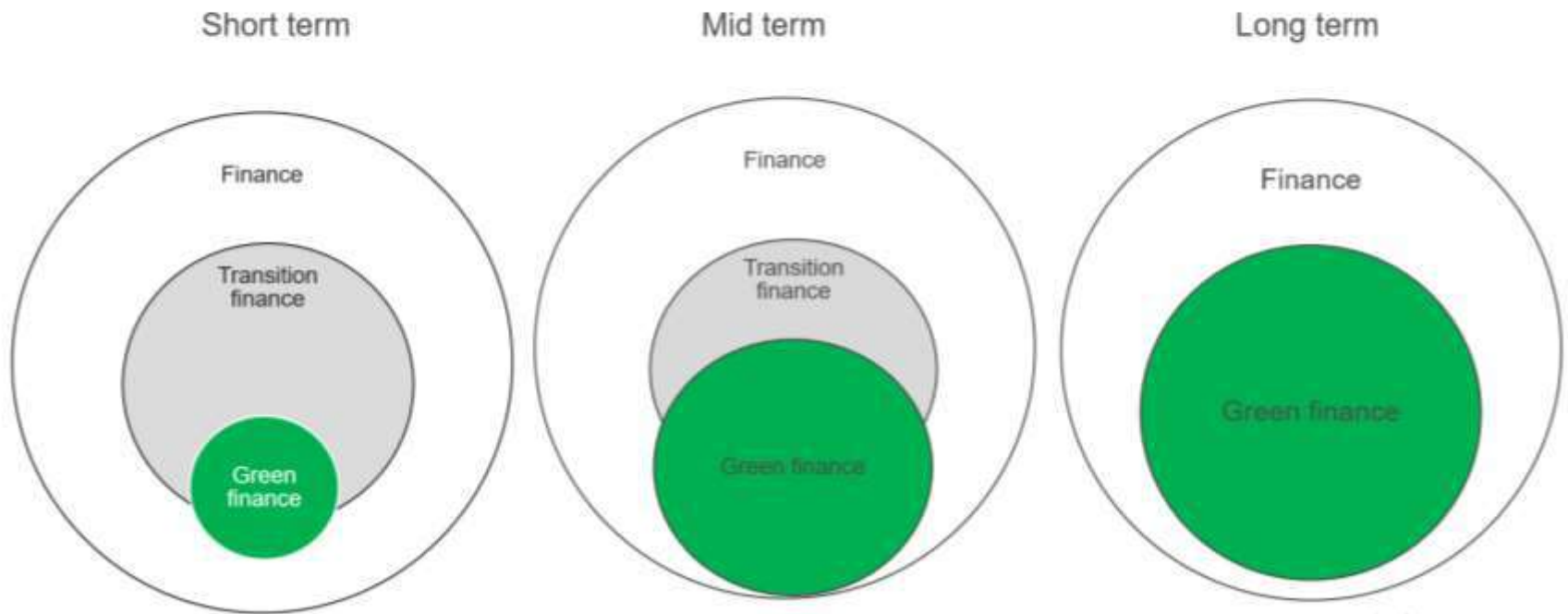
New mandate of the Platform on SF

- **Two-year mandate:** Q1 2023 to Q4 2024.
- Three key workstreams on which the Platform support the Commission with advice and analysis on:
 - the **usability** of the Taxonomy and wider sustainable finance framework;
 - the development of recommendations for **additional Taxonomy** and on possible **revisions/updates** of criteria;
 - the implementation of the Strategy on Financing the Transition to a Sustainable Economy, esp the **monitoring of capital flows** into sustainable investments.

The broader sustainable finance framework

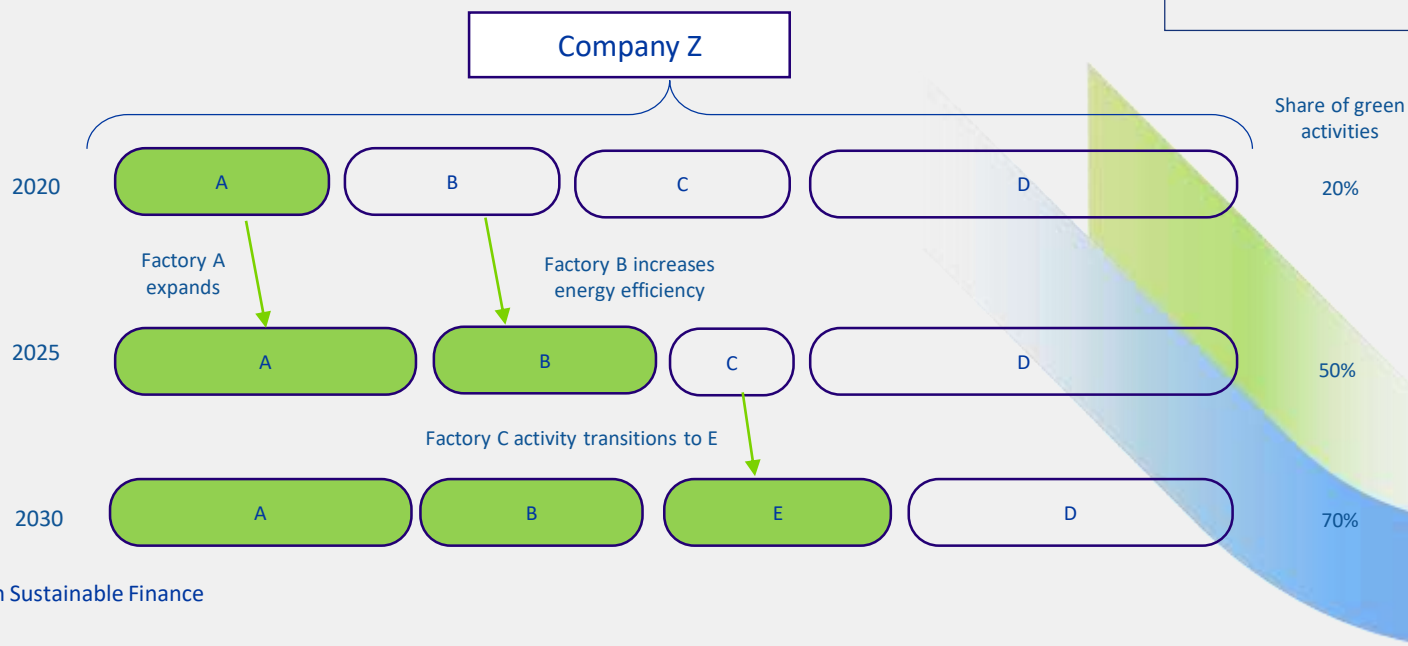
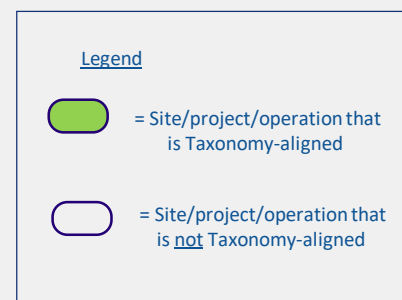
Transition Finance

Relationship between green and transition finance today and over time



Transition tool - how can taxonomy help?

- By defining green economic activities, not companies
- The Taxonomy enables companies to transition by gradually increasing their share of green activities



Corporate Sustainability Reporting Directive

Wider scope:
all large & all
listed &
certain non
EU
companies

**Mandatory EU
sustainability
reporting standards**

**Assurance
(audit)
requirement**

- ✓ Clarity and certainty on sustainability information for reporting companies and users
- ✓ Coherence with EU's ambitions and framework: EU standards that will cover all sustainability information from the double materiality perspective
- ✓ Critical importance of the transition plans
- ✓ EU standards build on and contribute to global standards, including ISSB
- ✓ Public consultation on the ESRS expected in coming weeks

Sustainable Finance Disclosures Regulation

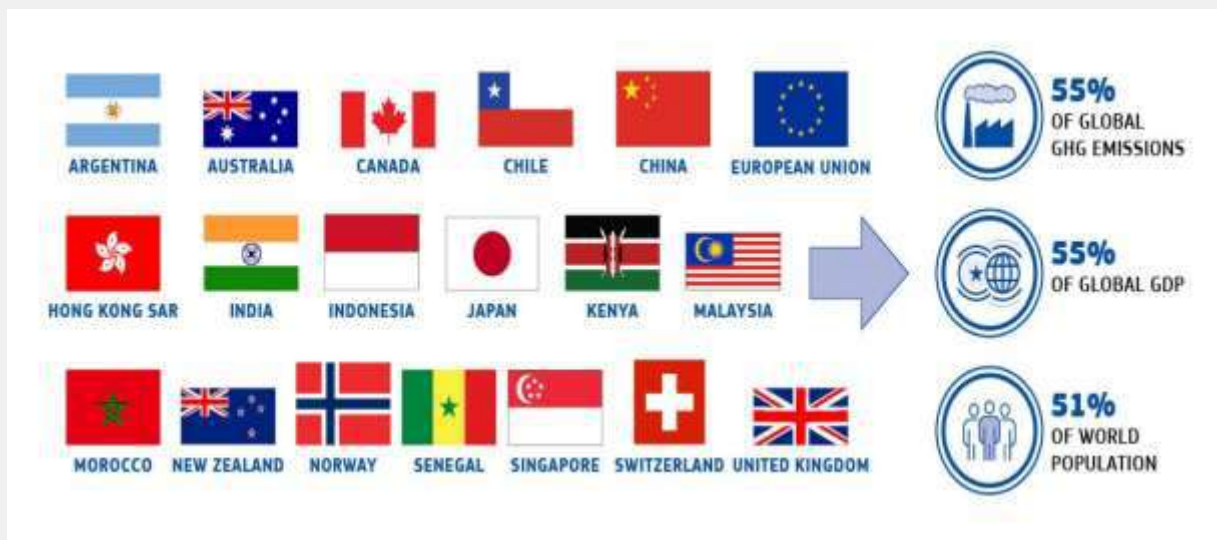
- ✓ Disclosures by financial market participants and financial advisers **at entity and product levels on the integration of sustainability risks and principal adverse impacts**. Additional product disclosures for sustainable financial products
- ✓ **Level 2** applicable since 1 Jan. 2023 – a revision is ongoing to enhance the RTSs
- ✓ **Several FAQs** to clarify the application of the SFDR
- ✓ **An assessment underway** to ensure SFDR's legal certainty, improve its usability and its role in mitigating greenwashing. An Open Public Consultation will be launched in the autumn, to be accompanied by roundtables and workshops with different stakeholder.



International Platform on Sustainable Finance - IPSF

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Observers



Any questions?



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