SUSTAINABLE FINANCE – TRANSITIONING TO A GREEN ECONOMY

INTRODUCTION

The 2015 Paris Agreement ratified by 189 countries spearheaded global efforts to combat climate change by cutting greenhouse gas emissions. The European Union (EU) has committed to becoming a climate-neutral continent by 2050 while the UK has committed to net zero emissions by 2050.

To transition to this climate-neutral environment, both the UK and EU have introduced a variety of regulations related to climate change as part of an effort to embed sustainable finance into the area's financial institutions.

According to the European Commission, sustainable finance is defined as the *"process of taking due account of environmental and social considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities"*.[1] During 2019/2020, the UK and EU introduced multiple climate documents to embed sustainable finance into financial systems to assist in the transition to a climate-neutral economic area.

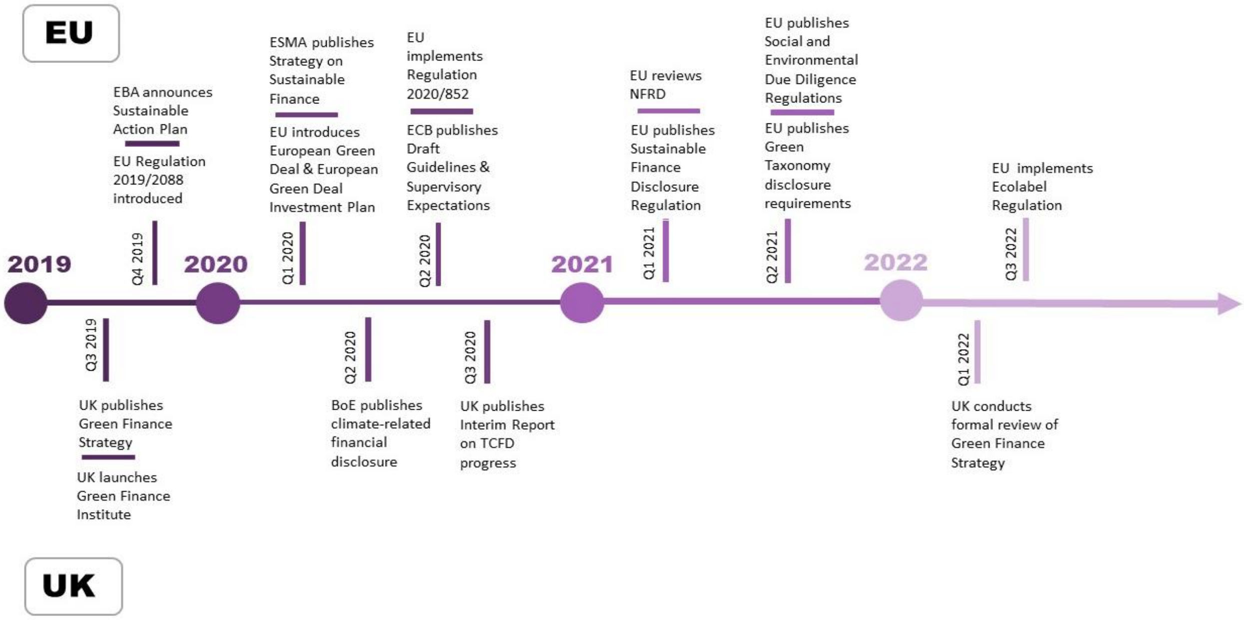
The objective of this short paper is to summarise key current documents, followed by an overview of upcoming guidance.

[1] European Banking Authority. (2019, December 6). *EBA action plan on sustainable finance*. https://eba.europa.eu/sites/default/documents/files/document_library/EBA%20Action%20plan%20on%20sustainable%20finance.pdf

KEY REGULATORY PUBLICATIONS – PAST AND FUTURE

The UK and EU have published comprehensive timelines, until 2022, for the introduction of climate regulations for financial institutions as illustrated by Figure 1.

Figure 1: Timeline of past and future UK and EU climate regulations for financial institutions



RECENT UK AND EU SUSTAINABLE FINANCE DOCUMENTS

UK GREEN FINANCE STRATEGY

In July 2019, the UK published its Green Finance Strategy which plans to unite the work of the Government, regulators, and the private sector under three key goals: (1) greening finance, (2) financing green, and (3) capturing the opportunity. Under the greening finance goal, UK regulators plan to improve the private sector's understanding of the climate-related financial risks and opportunities as a well as to establish a clear outline on each regulator's role and responsibility in this green finance transition. UK regulators also plan to establish long-term policy frameworks to improve private-sector access to green finance as well as develop innovative approaches to increasing green investments and reducing market barriers. Under its final goal, the Green Finance Strategy outline how the Government plans to work with the Green Finance Institute to establish the UK as a global hub for green finance and as a global leader for green finance innovation and opportunities within the private sector.[2]

[2] HM Government. (2019, July). *Green Finance Strategy*. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf

EU REGULATION 2019/2088 AND EBA SUSTAINABLE ACTION PLAN

EU Regulation 2019/2088 was introduced in November 2019 to establish clear, unified rules for financial institutions and advisors concerning the transparent integration of sustainability risks. The regulation requires financial market participants to publicly disclose their policies regarding the integration of sustainability risks in investment decision-making processes. Financial market participants are also required to disclose the promotion of ESG characteristics and sustainable investments in periodic reports to the Commission.

In December 2019, the European Banking Authority (EBA) introduced a comprehensive strategy, known as the Sustainable Action Plan, to further integrate sustainable finance with financial market participants. The Sustainable Action Plan has 3 key goals: (1) reorienting capital flows towards sustainable investment, (2) mainstreaming sustainability into risk management, and (3) fostering transparency and long-termism. The action plan amends previous EBA regulations, revises CRR 2 and CRD 5 requirements, implements new Investment Firms Regulation (IFR) and Investment Firms Directive (IFD) regulations, and invokes a financing sustainable growth plan as illustrated in Figure 2.[3]

Figure 2: Overview of EBA mandates on sustainable finance[4]

EU GREEN DEAL & EU GREEN DEAL INVESTMENT PLAN

In January 2020, the EU introduced the European Green Deal as a comprehensive environmental plan to boost the efficient use of resources by moving to a clean, circular economy as well as to mobilise EU funding to facilitate and stimulate the public and private investments needed the transition.

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[3] European Banking Authority. (2019, December 6). *EBA action plan on sustainable finance*. https://eba.europa.eu/sites/default/documents/files/document_library/EBA%20Action%20plan%20on%20sustainable%20fiance.pdf
[4] European Banking Authority. (2019, December 6). *EBA action plan on sustainable finance*. https://eba.europa.eu/sites/default/documents/files/document_library/EBA%20Action%20plan%20on%20sustainable%20fiance.pdf

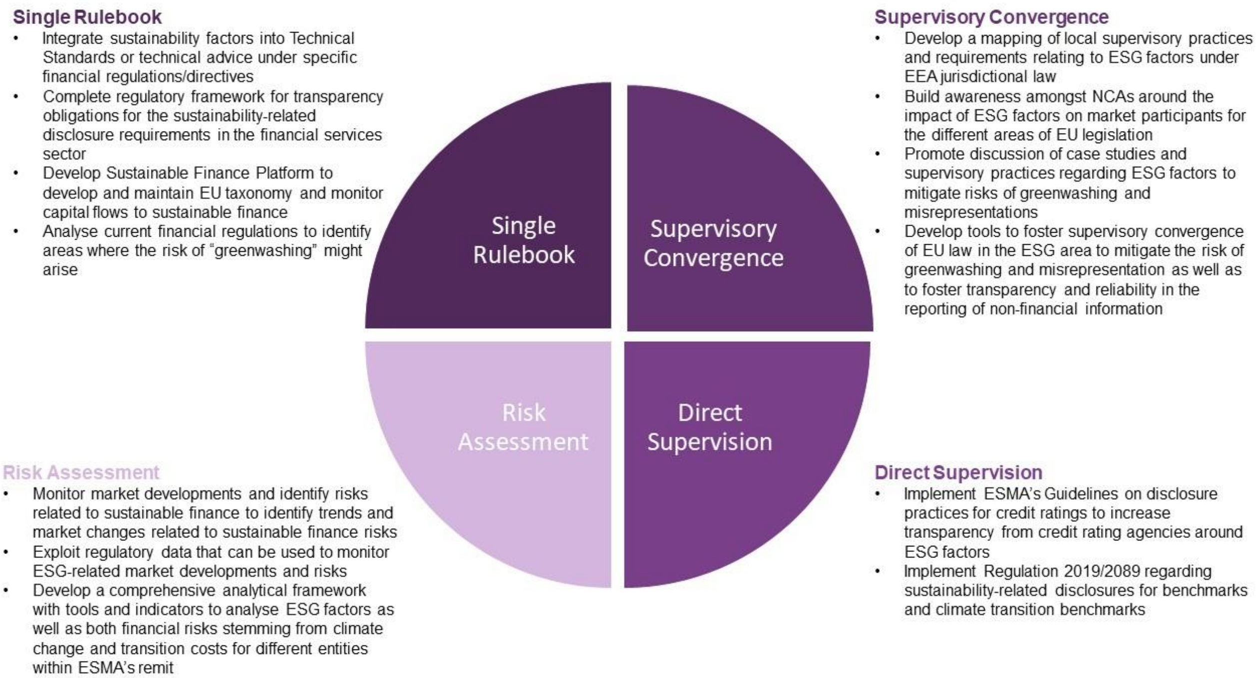
The European Green Deal Investment Plan was introduced in conjunction with the European Green Deal to mobilise public investment and unlock private funds through EU financial instruments such as InvestEU. The European Green Deal Investment Plan is based on three key dimensions: financing, enabling, and practical support to integrate approximately €1 trillion of sustainable investments into the EU financial system[5]. The Plan also included the Just Transition Mechanism, a plan to provide targeted financial and practice support to specific regions to ease the socio-economic impact of the climate-neutral transition. This mechanism would inject roughly €100 billion of investments into the EU financial system through various channels including the Just Transition Fund, InvestEU, and European Investment Bank.[6]

ESMA STRATEGY ON SUSTAINABLE FINANCE

The European Securities and Markets Authority (ESMA) published the Strategy on Sustainable Finance in February 2020 to outline the authority’s approach for identifying sustainable business models and integrating ESG factors into its sustainable finance activities.

The ESMA strategy covers four key areas: (1) single rulebook, (2) supervisory convergence, (3) direct supervision, and (4) risk assessment which are explained in depth in Figure 3.

Figure 3: ESMA Strategy on Sustainable Finance[7]



[5] *Financing the green transition: The European Green Deal Investment Plan and Just Transition Mechanism* [Press release]. 2020, January 14). https://ec.europa.eu/commission/presscorner/detail/en/ip_20_17
[6] *Financing the green transition: The European Green Deal Investment Plan and Just Transition Mechanism* [Press release]. 2020, January 14). https://ec.europa.eu/commission/presscorner/detail/en/ip_20_17
[7] *Strategy on Sustainable Finance*. (2020, February 6). European Securities and Markets Authority. https://www.esma.europa.eu/sites/default/files/library/esma22-105-1052_sustainable_finance_strategy.pdf

ECB DRAFT GUIDELINES & SUPERVISORY EXPECTATIONS & EU REGULATION 2020/852

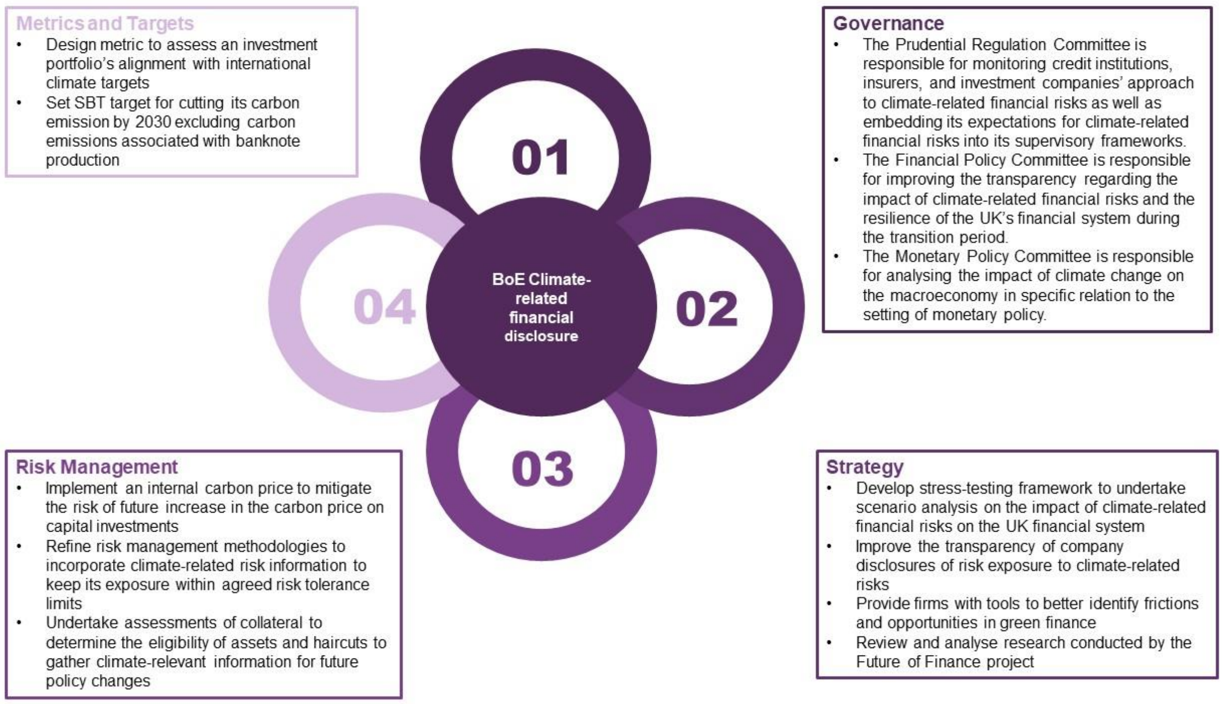
In May 2020, the ECB published a consultative on banking expectations related to the management of climate-related and environmental risks which would then be transparently disclosed under the prudential framework.[8]

The EU implemented Regulation 2020/852 in June 2020 as a framework to facilitate sustainable investment and amend certain aspects of Regulation 2019/2088. This regulation, known commonly as the Taxonomy Regulation, established criteria to determine whether an economic activity was environmentally sustainable which would encourage greater private sector involvement in the adoption of sustainable finance.[9] Regulation 2020/852 also expands upon the disclosure requirements from Regulation 2019/2088 by obligating pre-contractual disclosures of sustainable finance products as a means of improving the transparency of disclosure requirements.

BOE'S CLIMATE-RELATED FINANCIAL DISCLOSURE

In June 2020, the Bank of England published its first climate-related financial disclosure outlining its approach to managing climate-related financial risks across the UK financial sector. The disclosure covers four key areas: (1) governance, (2) strategy, (3) risk management, and (4) metrics and targets which are explained in detail in Figure 4.

Figure 4: BoE's Climate-related Financial Disclosure approach[10]



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[8] In September 2020, Avantage Reply published a response to the ECB's consultative document.

[9] 'Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088' (2020) *Official Journal* L198, p. 13-43

[10] *The Bank of England's climate-related financial disclosure 2020*. (2020, June). Bank of England. https://www.bankofengland.co.uk//media/boe/files/annual-report/2020/climate-related-financial-disclosure-report-2019-20.pdf?la=en&hash=5DA959C54540287A2E90C823807E089055E6721B

CHALLENGES FOR FINANCIAL INSTITUTIONS – AND HOW CAN WE ASSIST?

Based on the regulatory direction of travel over the next few years, financial institutions must begin to consider enhancing risk management practices to reflect new requirements. The new disclosure requirements that have been introduced in 2019/2020, as well as the predicted future regulations, will require financial institutions to adjust their risk modelling techniques, including scenario analysis and stress testing, to account for short and long-term financial impacts from ESG factors.[11]
Financial institutions also need to consider methods to appropriately capture and process financial data, specifically climate-relevant data, as this will develop the accuracy and reliability of their risk modelling techniques. Stress testing approaches need to consider climate-related impacts in the assessment of financial institutions' viability, sustainability and resilience.

These are just a few brief examples of risk management techniques that should be used by financial institutions to respond to present and future regulatory changes in sustainable finance. Financial institutions should of course re-evaluate any existing risk management practices following the implementation of future UK and EU regulations regarding climate change to ensure appropriate compliance.

Given the rapidly changing landscape of climate regulations in the UK and EU, financial institutions need to adjust risk management practices to better integrate sustainable finance into their operating and decision-making processes.

In this context, Avantage Reply supports clients with:[12]

- setting-up the framework and processes to identify financial risk from climate change and document this in the relevant internal documents (e.g. ICAAP and ILAAP);
- defining a framework, policies and processes to monitor and manage material climate risks;
- identifying additional data and relative taxonomy that the institution may need to improve risk assessments;
- developing quantitative and qualitative risk modelling solutions for climate-risk assessments.

CONCLUSION

It has become increasingly clear in recent years that substantial changes must be made to the European financial system to achieve the targets of the 2015 Paris Agreement as well as the individual goals of the UK and EU. Governments and regulators must encourage financial institutions to increase the transparency of disclosures specifically regarding the integration of sustainable finance into investment decision-making and the risk management techniques for ESG factors.

Financial institutions should see these recent strategic plans and regulatory changes as an opportunity to adjust decision-making processes and risk management practices to accurately capture climate-related risks and opportunities. Financial institutions should also be aware of future regulatory changes that could further impact risk management practices and financial operations in both the UK and EU's efforts to tackling climate change.

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[11] van der Vaeren, H., Rossi, C., & Saravanabavan, G. (2020, May). *Beyond Green Banking, Climate Change is Changing Prudential Supervisory Expectations for Banks*. Avantage Reply.
[12] van der Vaeren, H., Rossi, C., & Saravanabavan, G. (2020, May). *Beyond Green Banking, Climate Change is Changing Prudential Supervisory Expectations for Banks*. Avantage Reply

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AVANTAGE REPLY

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