TRUST Finance

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Introduction to Sustainable Finance Regulation

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Essential Question

- Why is it important that there exists appropriate laws, regulations, frameworks and standards to ensure effective adoption and implementation of sustainable finance?

  - The requirements for **international laws**, **regulations**, **frameworks** and **standards** pertaining to sustainability and sustainable finance.
  - Sustainable finance as a mechanism to promote the **development of sustainable assets** – **sustainable investing** and **financial services**.
  - Sustainable finance as a mechanism to **hold organisations to account** - and **Environmental Social and Governance** / **Sustainability reporting**.

Sustainable Finance

- developing discipline
- sustainable business model
- mitigating the impacts of climate change
- Economic, Social and Governance (ESG)
- a good financial system does not operate separately from business operations, planning and management

Sources of Regulation

- Domestic Legislation
- EU Legislation
- International Treaties and Agreements*
- Professional and Ethical Standards

* The EU is the only party to the Paris Climate agreement that is not an individual country. Member States are still responsible for their obligations under the treaty, but the EU and Member States have committed to working together in their response to climate change.

Initiatives Driving Sustainable Finance

The Paris Agreement:

- Temperature Goals.
- Nationally Determined Contributions.
- Transparency and Accountability.
- Climate Finance.
- Global Stocktake.

European Green New Deal:

- Climate Neutrality.
- Clean Energy Transition.
- Sustainable Industry.
- Sustainable Mobility.
- Biodiversity and Farm to Fork.
- Just Transition.

Initiatives Driving Sustainable Finance

Existing Standards and Regulation:

- **Domestic Legislation**

  Legislation that has been enacted in the individual countries.

- **EU Legislation**

  A range of Directives and Regulations that apply to all countries across the European Union (EU).

- **International treaties and agreements**

  Global and regional agreements on how to deal with matters relating to business, law or other matters.

- **Professional and Ethical Standards**

  Detailed rules and requirements applied to professionals that advise on investment, legal interpretation, accounting and auditing.

International Agreements and Recommendations:

- **Financial Action Task Force (FATF)**

  Prevention of money laundering and terrorist financing (Financial Action Task Force, 2023).

- **The Basel Accords**

  Banking regulation agreed via the Basel Committee on Bank Supervision (Bank for International Settlements, 2023).

- **Organisation for Economic Cooperation and Development (OECD) and G20**

  Inclusive framework on base erosion and profit shifting (BEPS) (Organisation for Coopreation and Development, 2023).

Sustainable Finance Funding

- World Bank delivered **$31.7 billion in climate** finance in 2022, with its **2021-2025** action plan **projecting $200 billion**.
- **EU** project that approximately **€2** trillion will be made available to support climate action **between 2021 and 2027**.
- **The US** will spend more than **$500 billion** on climate technology and clean energy in the coming years.

- These amounts are enormous, but they pale into insignificance when you consider the potential impact of climate change.
- Deloitte Economics Institute has estimated that **climate change** could cost between **$1.7 trillion and $3.1 trillion per year by 2050**.

The Argument for Regulation

- Many investors face challenges to ensure that resources are allocated to green projects that will deliver the required outcomes in terms of climate change.
- Invested in a range of capital investment and behaviour change initiatives needing a consistent and reliable standard of reporting on:
    - The decision-making processes in making sustainable investments.
    - The performance of these investments.
    - How the organisations are effectively reporting on the results of sustainable initiatives.
- Currently there are very few globally agreed standards and regulations in this area.
- There is a need to be able to offer robust financial and non-financial evaluation models, deploy appropriate budgeting and project management techniques, and to evaluate the outcomes of those projects or investments.
- There are several different regulations and standards in relation to sustainable finance, ESG reporting, ESG investing and similar areas competing for supremacy.

Regulation in Sustainable Finance

- **This lesson:**
  - EU Regulations and Directives

- **Next lesson:**
  - Other international treaties, agreements and standards.

EU Regulation

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European Commission definition of Sustainable Finance

Sustainable finance refers to the process of taking **environmental**, **social** and **governance** (ESG) considerations into account when making investment decisions in the financial sector, leading to more long-term investments in **sustainable economic activities** and projects.

European Commission

2018: THE FOUNDATIONS OF THE EU SUSTAINABLE FINANCE FRAMEWORK

1. EU TAXONOMY

A common classification of economic activities substantially contributing to environmental objectives, using science-based criteria.

- Taxonomy Regulation: **adopted** on 18 June 2020

2. DISCLOSURES

Comprehensive disclosure regime for both non-financial and financial institutions to provide investors with the information necessary to make sustainable investment choices.

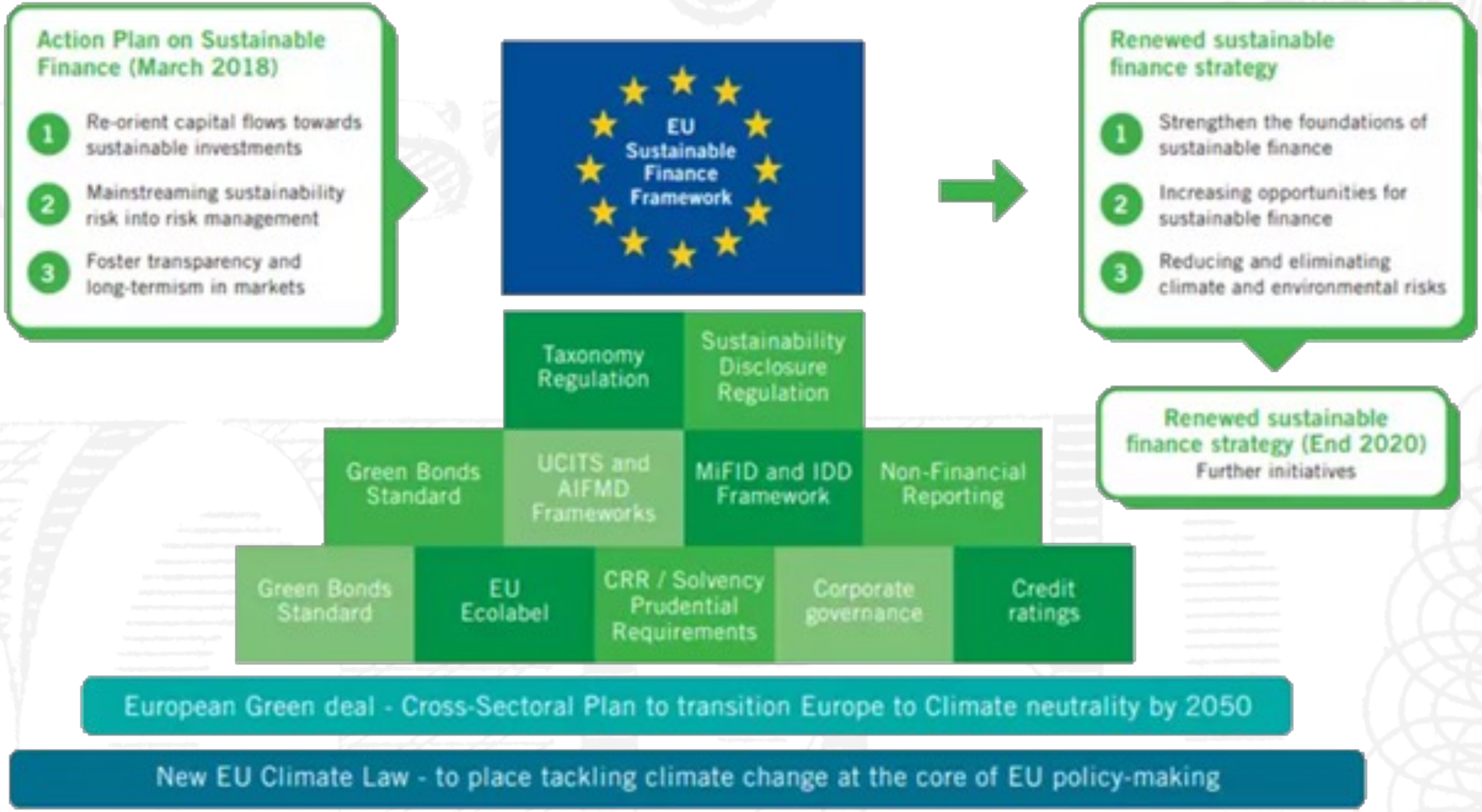
- Sustainable Finance Disclosure Regulation (SFDR) **applies** since March 2021
- Corporate Sustainibility Reporting Directive (CSRD) **proposed** by the Commission in April 2021
- Sustainability preferences: **adopted** by the Commission in April 2021

3. TOOLS

Broad toolbox for companies, market participants and financial intermediaries to develop sustainable investment solutions, while preventing green washing.

- EU Climate Benchmarks Regulation **applies** since April 2020
- Standard for European green bonds (EuGB), **proposed** by the Commission today

EU Sustainable Finance Framework



Source: Irish Funds

European Union Sustainable Finance Timeline

30/11/2016
High-Level Expert Group on Sustainable Finance

18/07/2017
Sustainable Finance Public Hearing

13/11/2017
Consultation with Institutional Investors and Asset Managers

08/03/2018
Action Plan for Financing Sustainable Growth

24/05/2018
Legislative Proposals on Sustainable Finance from the EU Commission

21/03/2019
High-Level Conference on a Global Approach to Sustainable Finance

10/12/2019
Financing the Paris Agreement - How to Mobilise Private Investors

14/01/2020
European Green Deal Investment Plan and Just Transition Mechanism

08/04/2020
Consultation on the Renewed Sustainable Finance Strategy

01/10/2020
EU Platform on Sustainable Finance Expert Group formed

21/04/2021
Sustainable Finance Legislative Package

06/07/2021
Sustainable Finance Strategy published

21/08/2021
Study on ESG Factoring into the EU Banking Prudential Framework

13/06/2023
Sustainable Finance Legislative Package

2016 | 2017 | 2018 | 2019 | 2020 | 2021 | *2022* | 2023

Fit for 55 (reduce greenhouse emissions by 55%)

- Boost the production of renewable energy.
- Improve energy efficiency.
- Increase carbon removals.
- Reform and expand emissions trading.
- Make transport more environmentally friendly.
- Support people to shift to a greener economy.

Sustainable Finance Disclosure Regulation (SFDR)

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Sustainable Finance Disclosure Regulation (SFDR)

- The SFDR is a regulation adopted by the EU in 2019 to promote sustainable finance and ensure transparency in the financial services sector.
- Helps investors seeking to invest in companies and projects supporting sustainability objectives to make informed choices.
- Allows investors to properly assess how sustainability risks are integrated in the investment decision process.
- Intention is to attract private funding to help Europe make the shift to a net-zero economy.

Sustainable Finance Disclosure Regulation (SFDR)

- **Applies to financial market participants such as:**
  - Banks.
  - Asset Managers.
  - Alternative Fund Managers.
  - Insurance Undertakings.
  - Undertakings for Collective Investment in Transferrable Securities (UCITS)
  - Pension Funds (including occupational).
  - Financial Advisors.
  - Insurance Fund Managers.
  - Management Companies (Managing Investments / Investment Funds).
- **Developed to improve transparency, reduce greenwashing, and direct capital towards more sustainable investments/products and businesses and incorporating sustainability goals into enterprise-wide risk management.**

Duties under the SFDR

Integrate ESG			Achieve Double Materiality		
Strategy→	Policy→	Risk Management→ Asset Selection→ Product Management→ Stewardship→	Investment	←Impact→	Global ESG Factors

Implementation under SFDR

Disclose ESG Data Policy +	Product Alignment +	Quantification of the Product Impact
Contracts with customers	Standards	Utilising standardised ESG metrics.
Marketing materials including information placed on the Internet	Comparability (across products)	
Reports	ESG definitions	

Disclosures

- **Level 1 disclosures** are disclosures required at an entity level on a "comply-or-explain" basis.
  - The require the disclosure of information by the "financial market participant" (FMPs) regarding its policies on the identification and prioritisation of "sustainability risks".
- **Level 2 disclosures** are more detailed disclosure requirements that go beyond the entity-level disclosures required at Level 1.
  - Level 2 disclosures include both entity-level and product-level information and are designed to provide more granular insights into the sustainability risks and impacts of financial products and services

Developments

- Applicable since March 2021, but it is difficult for financial market participants to disclose appropriate information under SFDR and the without access to robust and reliable corporate sustainability data.
- The European Commission has established expert groups such as the *Technical Expert Group on Sustainable Finance* and *the High-Level Expert Group on Sustainable Finance* to assist in developing its sustainable finance work.
- The *European Supervisory Authorities* (EBA, EIOPA, and ESMA) have proposed amendments to the SFDR to address issues that have emerged since its introduction:
    - Extending the list of universal social indicators for the disclosure of the principal adverse impacts of investment decisions on the environment and society
    - Refining the content of other indicators for adverse impacts.

EU Taxonomy Regulation

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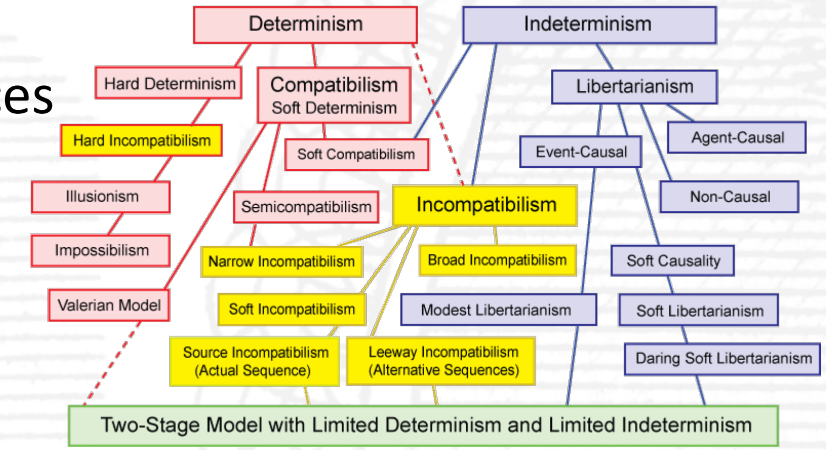
European Union Taxonomy Regulation

- Classification system for the identification of environmentally sustainable activities.
- It applies to financial market participants offering financial products in the EU and large public-interest entities with more than 500 employees
- Based on six environmental objectives:
  - Climate change mitigation
  - Climate change adaptation
  - Sustainable use and protection of water and marine resources
  - Transition to a circular economy
  - Pollution prevention and control
  - Protection and restoration of biodiversity and ecosystems



Environmentally Sustainable

- To be considered environmentally sustainable under the taxonomy, it is required to contribute to the achievement of one or more of the six objectives.
- Must “do no significant harm” to the achievement of any of the 6 objectives.
- Must comply with minimum safeguards.
- Must comply with technical screening criteria.
- The taxonomy pushes finance providers and investors to meet minimum social safeguards and comply with technical screening criteria.

Overall Intention

- To standardise the classification of the vocabulary used to identify environmentally sustainable commercial activities.
- Provide a level of transparency and legal certainty when communicating on sustainable endeavours

Low Carbon Benchmark Regulation

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Low Carbon Benchmark Regulation

- Disclosure requirements for the creators / administrators of benchmarks with respect to the ESG factors that form part of any benchmark.
- Includes the methodology for calculating the benchmark.

Key Milestones

- **Regulation (EU) 2016/1011)** – provides for the regulation of the **benchmarking of financial instruments**, or financial contracts and on the performance of investment funds
- **Regulation (EU) 2019/2089** – adding "*EU Climate Transition Benchmarks*", "*EU Paris-aligned Benchmarks*" and "*sustainability related disclosures*" to existing benchmarking regulation.
- **Commission Delegated Regulation (EU) 2020/1816** – providing an "*explanation in the benchmark statement of how environmental, social and governance factors are reflected in each benchmark provided and published*".
- **Commission Delegated Regulation (EU) 2020/1817** – outlining "*the minimum content of the explanation on how environmental, social and governance factors are reflected in the benchmark methodology*".
- **Commission Delegated Regulation (EU) 2020/1818** – establishing the "*minimum standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks*" (European Union, 2020).

Two Categories

- EU Climate Transition Benchmarks (Low Carbon Benchmarks):
    - Standard benchmarks, similar to the FTSE 100 or the CAC 40, but with lower carbon emissions.
    - They select, weight, or exclude companies based on their carbon emissions.
- EU Paris-aligned Benchmarks:
    - Go further than the Low Carbon Benchmarks and select companies that can demonstrate they are making a positive impact in the achievement of the goals of the Paris Climate Agreement, targeting the restriction of global warming to no more than 2^{o}C above the conditions that were in existence before the industrial revolution of the late 18th Century.

Function

- To help investors align their portfolios with their environmental objectives and reduce the risk of greenwashing.
- Clear framework for financial market participants to disclose how their methodologies align with the objectives of the Paris Agreement.

Features

- The Benchmarks must include certain “Scope 3” Greenhouse Gas emissions data.
- The use of weighting within the benchmark.
- The benchmark must include specified targets based on setting a decarbonisation trajectory.
- Certain companies are excluded from the benchmark (see next slide).
- Compliance with certain transparency (disclosure) and accuracy standards.

Companies Excluded from the Benchmark

- Companies that produce “controversial” weapons.
- Tobacco companies.
- Companies that are found to be in violation of certain international agreements.
- Companies with revenue that includes more than 1% from mining, drilling, extracting, refining and / or distributing a number of specified fossil fuels.
- Certain “dirty” electricity generators.
- Any company that harms any one or more of the environmental objectives provided for in the Taxonomy.

Corporate Sustainability Reporting Directive (CSRD)

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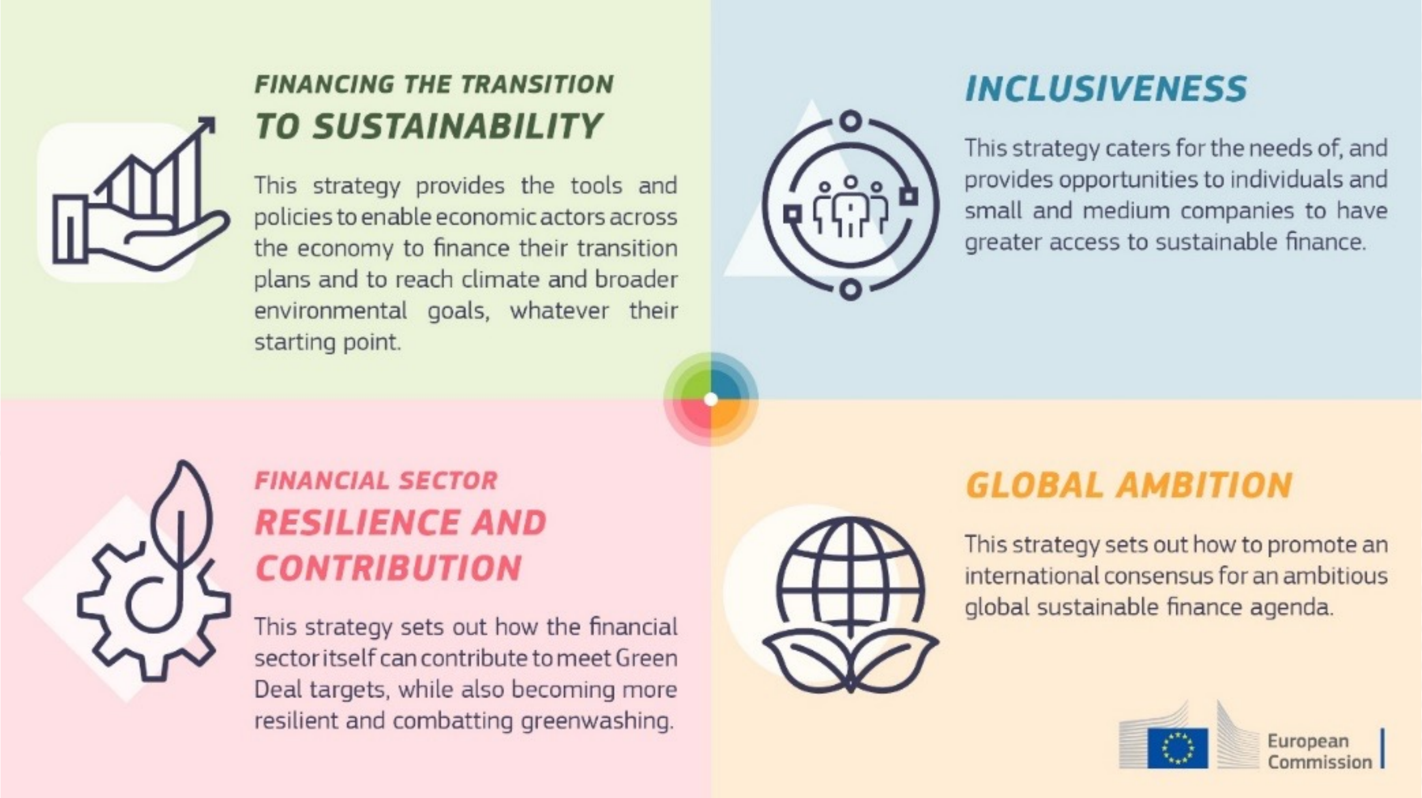
Why a Corporate Sustainability Reporting Directive?

- To improve the disclosure process.
- Provide investors and consumers with a simpler, more consistent way to understand and compare the environmental, social, and governance (ESG) impact of an organisation's activities.
- Make better-informed decisions based on sustainability data.



Key Features of CSRD

- Requires large companies within the EU to make disclosures on how their activities impact people and the planet, including their sustainability risks.
- Address shortcomings identified with in existing legislation on the disclosure of non-financial information.
  - It applies more detailed reporting requirements on companies' impact on the environment, human rights, and social standards.
  - It expands the number of companies covered by the Directive from approximately 11,700 to approximately 50,000.
- Covers roughly 80 requirements that include both quantitative and qualitative disclosures
  - These requirements extend to various areas such as working conditions, respect for human rights, fundamental freedoms, democratic principles, and standards established in the International Bill of Human Rights and other core UN human rights conventions.
- Companies are also required to engage with their value chains, including suppliers.

CSDR Auditing and Certification

- Companies will be subject to independent auditing and certification.
- The terms of the CSRD require sustainability reporting to be checked externally when the CSRD takes effect.
- Companies will need to seek limited assurance of the sustainability information.

Standards and Frameworks

- Standards to be consistent with other European legislation but they do not point towards any one international standard or framework as a model.
- Refers to the broad objective of taking into account existing standards and frameworks such as:
    - the Global Reporting Initiative (GRI),
    - the Sustainability Accounting Standards Board,
    - the Task Force on Climate Related Financial Disclosures (TCFD),
    - the Climate Disclosure Standards Board,
    - the International Integrated Reporting Council,
    - the International Accounting Standards Board, and any standards developed under the auspices of the IFRS Foundation

more on these standards next week

Standard for European Green Bonds (EuGB)

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Standard for European Green Bonds

- Regulatory framework established by the EU to promote environmentally sustainable economic activities.
- To provide a clear and reliable standard for “green bonds” increasing transparency and making it easier for investors to identify and invest in genuine green projects.
    - Intended to boost the green bond market by providing a trusted standard that ensures the environmental integrity of these financial products
- Based on the EU Taxonomy.
- Open to all issuers, both within and outside the EU
- Applies to any type of listed or unlisted bond or capital market debt instrument issued by a company, bank, or public sector entity.

Conclusion and Next Lesson

- EU Developments in Sustainable Finance are considerable:
  - Sustainable Finance Disclosure Regulation.
  - EU Taxonomy Regulation.
  - Low Carbon Benchmark.
  - Corporate Sustainability Reporting Directive.
  - Standard for European Green Bonds.
- This is not yet a settled area in terms of regulations or standards.
- Likely to be a considerable number of new developments over the next few years.

- Other Developments:
- Global Reporting Initiative.
- Sustainability Accounting Standards Board.
- Task Force on Climate Related Financial Disclosures.
- Climate Disclosure Standards Board.
- International Integrated Reporting Council.
- the International Accounting Standards Board, and any standards developed under the auspices of the IFRS Foundation.

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