Background Note

From transparency to sustainability: Environmental, Social and Governance (ESG) objectives in financial services

Ensuring financial markets contribute their fair share in sustaining environmental, social and governance objectives has been at the centre of concerns for some time now (see als see Commission website on green finance). In September 2016, the Commission's progress report on Capital Markets Union already pointed to reforms for sustainable finance being necessary to support investment in clean technologies, ensure that the financial system can finance growth in a sustainable manner over the long term, and contribute to the creation of a low carbon, climate resilient economy. Such concerns were framed in the context of meeting the EU climate and environment objectives, the EU international commitments, including under the Paris Agreement on climate change, and the objectives of the 2015 Circular Economy package (see Commission website on circular economy initiatives). This note focuses on how financial services have been addressees of policies tackling climate change. An additional background note addresses climate change in other policy areas.

Sustainable (green) finance: *internal* dimension

As the Commission puts it "*'Green finance' generally refers to the process of taking due account of environmental and social considerations when making investment decisions, leading to increased investment in longer-term and sustainable activities.*". Three main axis - environment, social and governance - underpin such policies. Sustainability, in this context, is understood "*as finance to support economic growth while reducing pressures on the environment and taking into account social and governance aspects. Green finance also encompasses transparency on risks related to ESG factors that may impact the financial system, and the mitigation of such risks through the appropriate governance of financial and corporate actors.*".

What are ESG factors?

ESG is frequently referred to – but what is covered within ESG? The table below contains a helpful summary:

Source: UNPRI

Work at EU level has been evolving around the priorities recommended by a High Level Expert Group (HLWG) set up by the Commission in December 2016. The Commission adopted in March 2018 an Action Plan on Financing Sustainable Growth building upon the HLWG recommendations. The Plan aims at (a) reorienting capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth; (b) managing financial risks stemming from climate change, environmental degradation and social issues; and (c) fostering transparency and long-termism in financial and economic activity. It foresees 27 actions around 10 clusters linked to the three priories above. Actions include, for instance, establishing a common language for sustainable finance ("taxonomy"), creating EU labels for green financial products, clarifying the duty of asset managers and institutional investors to take sustainability into account in the investment processes and enhancing disclosure requirements, requiring insurance and investment firms to advise clients on the basis of their preferences on sustainability, incorporating sustainability in prudential requirements (including the so-called green supporting factor) and enhancing transparency in corporate reporting.

Legislative and non-legislative work is ongoing, with tangible progress in a number of files. Two legislative texts have been adopted at the end of the European Parliament's eight term. The first, amended the Benchmark Regulation by introducing EU Climate Transition and Paris-Aligned Benchmarks. The second, proposal introduced new disclosure requirements in the field of financial services. On 18 of December 2019, a political agreement was reached on the Taxonomy proposal and the finalisation of the legislative process is expected by June 2020. On 14 January the Commission put forward its proposals for European Green Deal Investment Plan comprising, namely, an "*enabling framework for private investors and the public sector to facilitate sustainable investments*" and "*support to public administrations and project promoters in identifying, structuring and executing sustainable projects*". Both areas could relate to financial markets, as well as the proposals to be addressed through the InvestEU. With a particular relevance for financial markets, the Commission relevant Communication[1] refers:

(a) Increasing appetite for investors in green bonds, and that offer is currently not matching demand[2]; therefore "*Private actors will need to provide the scale.*";

[1] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on a Sustainable Europe Investment Plan - European Green Deal Investment Plan.*

[2] "*The annual global issuance of green bonds has tripled since 2016, reaching around EUR 225 billion in 2019 according to the recent estimates. A framework is needed to bridge the gap between policy objectives and the significant private financial resources available.*". On that same topic see additionally the study published by the European Banking Federation and the Institute for International Finance last 28 January. Most prominently, the study points that "*Supply and demand of sustainable instruments is on the rise: More than half of respondents already issue their own sustainable instruments and 89 percent of respondents expect demand for sustainable investments to grow in 2020.*".

(b) "*Financial institutions and private investors need to have the tools to properly identify sustainable investments. Notably, the EU taxonomy, the energy efficiency first principle and sustainability proofing will be key to leverage their firepower.*", in the context of the "*enabling framework*" referred to above.

In its Communication, the Commission further highlights:

(c) that "*direct support to public and private project promoters*" will be reinforced;

(d) its intentions of (i) enhancing the climate and environmental tracking and the sustainability proofing guidance in the second half of 2020 (using in an appropriate way the criteria established by the EU taxonomy) and (ii) developing, in cooperation with InvestEU implementing partners, financial products to be deployed under InvestEU targeting environmental, climate and social sustainability;

as well as the objectives of

(e) promoting a shift in investment decisions: "*the Sustainable Europe Investment Plan will enable the transition through targeted actions in areas that directly touch upon investment decisions of private investors and public entities.*", namely through implementing the various measures put forward in the 2018 Action Plan on Financing Sustainable Growth and others such as (i) the review the Non-Financial Reporting Directive[3] to increase disclosure of climate and environmental data (to raise awareness on available sustainable investment opportunities); (ii) defining clear labels for sustainable investment products; and (c) developing and implementing an EU green bond standard.

The Commission announced as well that it will issue in 2020 the delegated acts on the climate change objectives of the EU Taxonomy and the delegated acts on the other environmental objectives of the EU taxonomy by the end of 2021; establish an EU Green Bond Standard in 2020; and consult on a renewed sustainable finance strategy to be put forward in the third quarter of 2020.

The European Parliament is contributing to this debate through a number of resolutions[4] and as co-legislator analysing and deciding on the Commission's proposals.

Sustainable (green) finance: *external* dimension

Sustainable finance is a clear concern of various other institutions. To name just a few, the European Supervisory Authorities[5] received various mandates to work on sustainable finance related issues and saw recently their mandates expanded to cover sustainable finance related subjects; the European Central Bank[6] or the European Investment Bank have also been working on sustainable finance. Likewise, work at the level of OECD, IOSCO[7], the G20 and the Financial Stability Board also focus on sustainability. Central banks, on the other hand, have created a Network for Greening the Financial System (NGFS) with the aim to promote best practices in the banking sector[8]. The United Nations also launched the "United Nations Environment Programme Finance Initiative" (UNEP FI)[9] which, in September 2019, launched a set of principles for

[3] For further information on non-financial reporting see the Commission website. According to the recently disclosed Commission 2020 Workplan, a review of this Directive is foreseen to Q4 2020.

[4] See, in particular, the European Parliament resolutions of 29 May 2018 on sustainable finance (2018/2007(INI)), of 14 March 2019 on climate change – a European strategic long-term vision for a prosperous, modern, competitive and climate neutral economy in accordance with the Paris Agreement (2019/2582(RSP)), of 25 October 2018 on the 2018 UN Climate Change Conference in Katowice, Poland (COP24) (2018/2598(RSP)), of 10 October 2019 on the 2021-2027 multiannual financial framework and own resources: time to meet citizens' expectations (2019/2833(RSP)) and of 15 January 2020 on the European Green Deal (2019/2956(RSP)).

[5] For further information see EBA, ESMA and EIOPA websites.

[6] See, namely, a recent speech by Andrea Enria on "Regulation, proportionality and the sustainability of banking".

[7] See, in particular, the IOSCO 2019 work programme and its Sustainable Finance Network.

[8] The NGSF has published, namely, "A Sustainable and Responsible Investment Guide for Central Banks' Portfolio Management".

[9] The UNEP FI "*is a partnership between UNEP and the global financial sector to mobilise private sector finance for sustainable development. UNEP FI works with more than 300 members – banks, insurers, and investors – and over 100 supporting institutions – to help create a financial sector that serves people and planet while delivering positive impacts. We aim to inspire, inform and enable financial institutions to improve people's quality of life without compromising that of future generations. By leveraging the UN's role, UNEP FI accelerates sustainable finance.*".

responsible banking, in addition to its encompassing work in addressing climate change[10]. The Commission recently announced it had signed with the International Monetary Fund a new Financial Framework Partnership Agreement that will boost their cooperation to tackle key challenges including climate change, and help countries achieve the Sustainable Development Goals. It had previously launched, together with the relevant authorities from Argentina, Canada, Chile, China, India, Kenya and Morocco, the International Platform on Sustainable Finance (IPSF).

Challenges ahead

Challenges going forward are multiple, ranging from political, geostrategic and technical. Based on the information above and looking at financial institutions' specific risks and challenges, one can namely refer to (a) an adequate measurement framework, so that risks can be measured and dealt with and their impact assessed on the basis of common methodologies; (b) adequate supervisory tools, resources and methodologies to address sustainability related risks and determine the appropriate corrective measures, if so needed; (c) a standardised accounting framework and sufficient (granular and quality) data to assess risks; (d) improved risk management and governance frameworks. Adequate cooperation and articulation among the various policy setters will also be of paramount importance going forward. Social and governance concerns will also need to be tackled, as the financial sector is being asked to embed a culture of sustainable corporate governance (see Commission 2020 workplan).

Some framing questions for the debate

How should sustainability risks in financial markets be addressed in the banking, insurance, and securities markets toolkit?

Should the financial markets legal framework be clarified to better address sustainability issues? In which areas should additional work be conducted?

How can parliaments contribute to the debate on sustainable finance with the private financial sector, notably on facilitating the financing of green transition?

[10] The UK, in partnership with Italy, will host COP 26, scheduled to take place from 9 to 20 November 2020. In January 2020, Mark Carney was appointed by the UK Prime Minister as Finance Adviser for COP26.