Making Sense of Sustainability: A Policy Perspective

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Since the Paris Climate Agreement of 2015, governments and regulators around the world have been implementing adaptation and mitigation measures to combat climate change.

More recently as part of those efforts, policymakers, particularly in Europe and Asia, have focused on financial services given the sector's critical role in facilitating private capital flows.[1] Yet new and evolving rules that differ by country, and may or may not be mandatory, are creating a patchwork of policy that can prove confusing and time consuming to understand and navigate.

In this article we make sense of sustainability regulations facing the global financial services sector and explore policy developments and implications. We identify five priorities of global sustainability policy today: enhancing transparency of climate risks across the financial ecosystem; establishing a common taxonomy or classification system for sustainable investments; ensuring appropriate governance and management accountability for climate risk; incorporating climate risk into capital rules; and encouraging market-based initiatives to scale up voluntary carbon markets.[2] In each of these areas, we provide an overview of developments, highlighting regional differences, and then conclude with key takeaways for financial market participants.

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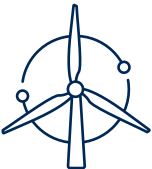

Enhancing transparency of climate risks across the financial ecosystem

Establishing a common taxonomy or classification system for sustainable investments

Ensuring appropriate governance and management accountability for climate risks

Incorporating climate risks into capital rules

Encouraging market-based initiatives to scale up voluntary carbon markets

Key takeaways for financial market participants

Enhancing transparency of climate risks across the financial ecosystem

Transparency has been a critical focus of regulators, globally, particularly with respect to promoting public disclosure of climate-related information. In this regard, policymakers are focused on two core aspects: Information that companies need to provide, primarily, to investors on climate-related risks and opportunities posed to their businesses; and information that financial products (including registered funds) need to provide.

The 2017 recommendations issued by the Financial Stability Board's Taskforce on Climate-Related Financial Disclosures (TCFD) provide a framework that is widely recognized amongst policymakers, regulators and industry stakeholders. Using this framework, companies can develop strategies to plan for climate-related risks and make their businesses resilient to the impacts of climate change.[3]

The largely voluntary nature of the TCFD framework to date, however, means that gaps and inconsistencies in corporate approaches to climate disclosures remain.

As a result, there has been a proliferation of global activity, both regulatory and voluntary, to address these gaps and inconsistencies in climate-related disclosure. However, as identified by the International Organization of Securities Commissions (IOSCO), this had led to over 30 different frameworks. The multiplicity and diversity of these frameworks make it difficult for companies to decide which is the most appropriate framework to report against.[4]

Efforts by the World Economic Forum (WEF) and International Business Council (IBC), which recommends 22 metrics based on TCFD and other existing standards-setters, in addition to the CFA Institute's ESG disclosure framework for financial products, are recent examples of industry efforts to coalesce around common standards and metrics.[5] Without clear government support or regulatory endorsement, these initiatives risk adding to the 'alphabet soup' of sustainability disclosure standards, while also making it difficult for investors and users of climate-related information to draw comparisons across companies and industries.

As regulators turned policy agendas toward sustainable finance, groups such as the Network For Greening the Financial System (NGFS) were established, and called on governments to adopt TCFD in 2019.[6] Since then, several jurisdictions have not only vocalized their support of the TCFD framework but have made serious headway in implementing the framework on a mandatory basis.

The most notable example is the United Kingdom following the UK government's 2020 roadmap which outlined full TCFD implementation across the financial services sector by 2025, starting with the largest pension schemes, premium listed entities and insurers.[7] Between the Department of Work and Pensions, the Financial Conduct Authority, the Bank of England/Prudential Regulation Authority, and other UK supervisors, there are already mandatory climate-related disclosures in place for certain issuers, asset managers, insurers, banks, and pension funds with varying implementation timelines for first reports in accordance with entity size. For example, pension fund requirements were entered into force October 2021, issuer requirements are expected in April, 2022 and asset manager first reports by June, 2023.

Prior to this, the EU had adopted a sustainability-focus extended beyond climate change as part of its Sustainable Finance Disclosures Regulation (SFDR). SFDR requires banks, asset managers, insurers and others to disclose sustainability-related risks, including adverse impacts, at the entity and product-level. Although this approach goes beyond the TCFD framework, the EU standard has somewhat influenced policy direction in other jurisdictions. For instance, the UK's FCA released its final policy statement concerning TCFD-like disclosures for asset managers at the end of 2021, which also adopts SFDR-like attributes in terms of providing disclosure at both the entity and product-specific levels.[8] In addition, the UK recently consulted on new Sustainability Disclosure Requirements (SDR) to introduce a labelling and classification system for financial products (including registered investment funds), mapping against existing SFDR classifications. State Street Global Advisors responded in January 2022, suggesting that further alignment with SFDR is essential given the financial services industry has already adopted SFDR classifications. It is fair to say that the EU's 'first-mover' advantage means that its ESG-related policy could be promulgated in many other jurisdictions.

One of the major challenges in meeting these new EU and UK requirements is the availability of clear, consistent, comparable and decision-useful information regarding the sustainability risks and opportunities posed to investee companies. It is widely acknowledged that there needs to be widescale improvement in the information publicly disclosed by companies. Yet, the European Commission delayed its planned review of the existing EU "non-financial reporting" rules until this year– and the new legislative proposal for a Corporate Sustainability Reporting Directive (CSRD) continues to make its way through the legislative process. Put simply, CSRD should have preceded SFDR.

The UK government had sought to prioritize disclosure by premium public companies, though constrained implementation timelines mean that climate-related disclosures are, effectively, being impinged on the largest actors across the investment chain at the same time. There are several factors likely driving this, not just in the UK but also in the EU and elsewhere.

The most obvious is that timing is clearly of the essence given the rapid pace and uncertainty at which climate change can manifest but also given the government's ambitious climate goals to achieve net zero.

Meanwhile, with the change in administration in the United States, the Securities and Exchange Commission (SEC) sought feedback on possible enhancements to issuer climate disclosures via a Request for Comment relating to climate disclosures in March, 2021.[9] State Street Corporation (including State Street Global Advisors) supported new SEC mandates for climate disclosure consistent with TCFD, noting certain challenges with more extensive requirements such as scope 3 GHG emissions reporting and assurance.[10]

The SEC issued a proposal for new mandatory climate risk disclosures on March 21, 2022, which introduces full disclosure in all issuers' registration statements and annual reports of Scope 1 and Scope 2 GHG emissions, with Scope 3 disclosures required when material or when a company has set explicit climate targets. The SEC has sought to limit compliance costs and burdens associated with such disclosure, by introducing a legal 'safe harbor' for companies' Scope 3 disclosures, in addition to a general phasing-in of the requirements over time. However, the SEC had proposed attestation for larger companies where they will be required to submit an independent report. The SEC proposal is highly controversial and already receiving pushback from various groups that consider it to be giving rise to increased costs and legal liability associated with climate-related financial reporting. It remains to be seen to what extent the current SEC proposal will survive in its current form, and could therefore significantly change once finalized.

With respect to investor/funds disclosure, the SEC had previously signaled an intent to mandate additional investor/fund ESG disclosure, possibly, via new requirements for ESG fund naming conventions (i.e. the SEC 'Names Rule') as well as additional disclosure requirements. The SEC 'Names Rule' essentially says that if you name a fund with an investment type, industry segment, or geography, it has to have at least 80% of the fund invested accordingly. Recent comments by SEC Chair Gary Gensler noting the increase in funds labelled "sustainable" / "ESG" / "low-carbon have raised speculation of changes to the SEC 'Names Rule'. However, it is not yet clear whether the SEC would consider 'ESG' to be an investment type or an investment strategy – an important factor as the latter is not captured under the existing SEC rules.

Recognizing the growing potential for regulatory fragmentation in this area and the potential cost on market participants, international standards-setters have identified globally consistent corporate sustainability reporting as an "urgent need".[11] The IFRS Foundation, as a result of increasing stakeholder pressure, has recently established a new International Sustainability Standards Board (ISSB) responsible for developing global standards leveraging off the TCFD and other widely-accepted frameworks, such as the Value Reporting Foundation (formerly, SASB). It remains to be seen to what extent a global baseline can be achieved as it depends on the uptake across major jurisdictions, particularly should the ISSB mandate move beyond climate risk to broader environmental and/or social risks, as is expected in due course. However, there is now a plausible path to achieve a single global standard.

Establishing a common taxonomy or classification system for sustainable investments

Even though private capital flows into environmentally sustainable investments have soared in recent years, inconsistent approaches to defining what constitutes sustainable investments and activities has led to a number of market participants remaining on the side lines when it comes to making a call on their respective sustainable investment approach.[12] Although we see an acceleration in widescale climate risk integration across the financial ecosystem, further clarity would be helpful.

A green taxonomy can be understood as a classification system to identify activities or investments that will move a country toward meeting specific targets related to priority environmental objectives.[13] The EU led worldwide on the first articulation of a list of economic activities that make a substantial contribution to environmental targets regarding climate change adaptation and mitigation. Such targets usually correspond to an aggregate outcome that a country wishes to achieve over a defined timeline, for example, a net reduction in emissions or deforestation by a given year. This is done by clearly defining which economic activities count as environmentally sustainable through the adoption of technical screening (or performance) criteria.[14]

Under the EU framework, companies and financial market participants – including asset managers, pension funds, banks and insurers – are expected to use the Taxonomy framework, including underlying screening criteria, in order to disclose a percentage of alignment across their businesses and/or portfolios.

The UK and Singapore have established taskforces comprised of private and public representatives to devise frameworks that align with the science-based targets underpinning the EU standard.[15] Emerging markets have also accelerated efforts to develop clear definitions of activities or investments that embody domestic national environmental objectives like addressing climate change or reducing deforestation.[16] At the international level, the possibility of a globally recognized green taxonomy was discussed at the G20 summit in Rome in 2021 but no agreement was reached.

Green taxonomies could help financial actors and others determine which investments can be labelled “green” for their jurisdictions and this could, in turn, encourage the undertaking of projects and activities that help scale up environmentally sustainable economic development and contribute to specific environmental objectives. The EU’s framework appears to be at the vanguard of green taxonomies, but the complexity and granularity of performance thresholds assigned

to sustainable economic activities has led to criticisms of its binary nature. Moreover, a study by the Finance Initiative (UNEP FI), in conjunction with the European Banking Federation, on the application of the EU Taxonomy revealed significant challenges faced in the banking sector arising from the lack of data and immature climate risk measurement methodologies.

We expect alignment around a common taxonomy will be slow going. There are many unanswered questions such as to what extent are these taxonomies becoming political? Does that diminish their effectiveness? How will data needs be met to cover multiple taxonomies? Will multinationals disclose only in line with their own (home) taxonomy? If so, what does that mean for an EU investor investing in US or UK securities? The aims of the various taxonomies are noble, but even with enhanced corporate disclosure to support them, implementation will not be straightforward.

Ensuring appropriate governance and management accountability for climate risks

Since the establishment of the United Nations Framework Convention on Climate Change in 1994, there has been increasing momentum around how boards manage and address climate-related risks and opportunities. The first pillar of TCFD, for instance, concerns the integration of climate-related risks into governance frameworks.

With supervisors, increasingly aligning their expectations to reflect the TCFD recommendations, there is a general focus on ensuring board-level attention on climate-related issues in addition to senior management expertise.

Furthermore, some supervisors – notably in the UK and EU, but also in Hong Kong and Singapore – have clarified that climate factors need to be specifically incorporated into the overall internal governance framework. This requires greater clarity around firms' strategic responses to climate-related risks informed by scenario analysis/stress tests (please see the next section), as well as alignment of remuneration policies with sustainability risk objectives. In terms of adapting business models to reflect the impact of climate change, the European Banking Authority, as an example, suggests setting a strategic ambition or target based on the Paris Agreement and aligning portfolios accordingly.[17]

From an asset management perspective, stewardship practices have played a crucial role in bringing about the necessary board-level/senior focus on climate-related risks and opportunities.

Stewardship codes have been focused on sustainability issues for some time, with the first being launched by the UK Financial Reporting Council in 2011, which has led to other jurisdictions (e.g., Japan) following suit.

The FCA consulted on an effective stewardship framework in 2019, as a complement to the existing Stewardship Code and to place greater emphasis on issues like climate change.

Meanwhile, the EU has recently published a legislative proposal on Corporate Due Diligence, which will apply initially to large EU limited liability companies before being extended to

mid-size companies in high-risk sectors (e.g., textiles, agriculture, forestry, food, mineral resource extraction, metals productions). It also proposed to apply the rules to certain non-EU companies operating in the EU market. The intention is to place greater focus on ESG risks emanating throughout the supply chain, together with new director duties.

At the international level, the UN Principles of Responsible Investing (PRI) was set up in 2001 and has become a globally recognized framework for signatories to demonstrate general sustainable investing credibility and the impact of their stewardship in the context of climate change.

Increasing regulation and investor pressure on corporations and financial market participants to embed climate risk in their organizational structures and processes are comforting signs to the market that these risks are taken seriously and as a result managed appropriately. In turn, management's messaging to the market would inherently become more credible improving their ability to raise capital to finance transition projects. Disclosures will improve as a consequence (and sometimes need to be already elevated as a prerequisite), data would become more readily available and investors' reliance on proxy or implied metrics would be reduced

Incorporating climate risks into capital rules

Central banks and financial regulators widely acknowledge that climate change poses a potential source of risk to the global financial system.[18] While other areas of policy often concern the full spectrum of sustainability risks, considerations for the banking sector have focused mainly on climate-related risks. Risks stemming from climate change can be categorized into physical costs resulting from things like adverse weather events or transition costs associated with moving towards a carbon-neutral economy.

Increasingly, banking and insurance regulators are exploring changes to provisions relating to governance, business strategy, risk management and disclosure, to ensure climate-related risks are properly accounted for and built into decision-making processes, including capital assessment and allocation.[19] We have seen policymakers and governments articulate this across three dimensions: supervisory practices and guidance; climate stress testing and scenario analysis; adjustments to capital requirements.

Climate risk is generally seen as cross-cutting, potentially manifesting itself in existing risk categories (i.e. underwriting, credit, market, operational and liquidity risk.) Operational risk in this context includes not only the impact on business continuity but also the extent to which an institution's activities or exposures could increase reputational and/or liability risks.

There is growing supervisory expectation for firms to fully integrate and embed climate risk considerations into processes over time. Following the 2019 NGFS recommendations to implement TCFD under the Basel III Pillar 3 framework, several national supervisors issued additional expectations.[20] For example, the UK Prudential Regulation Authority was among the earliest to set out expectations for banks and insurers as to how to strategically manage financial risks from climate change, embedding their strategic approaches by the end of 2021.[21] Supervisory authorities in the EU (e.g., France and Germany) as well as in the Asia-Pacific region (e.g., Australia, Singapore and Hong Kong) indicated that they will publish similar guidance. More recently, the US OCC consulted on high level principles.

In addition, some supervisors have laid out expectations for firms to integrate climate risk into the capital assessment process. This includes the quantification of material risks through scenario analysis exercises as well as, supervisory stress testing. Climate stress testing exercises currently take the form of 'top-down' assessments, leveraging supervisory statistics and datasets, and varying in terms of the type of climate-related risks in focus (i.e. only physical risk, transition risk, or both combined), as well as the granularity in which these risks are assessed.[22] Two examples include the Bank of England 2021 Biennial Exploratory Scenario on the financial risks from climate change and the Banque de France climate pilot exercise.[23]

The European Central Bank (ECB) published proposed methodologies and details of its scheduled stress test on Eurozone banks in 2022. These exercises are not intended to set capital requirements, rather they establish three climate-related scenarios (early action, late action and no action) on the basis of the NGFS work and are meant to be learning exercises to enable authorities and industry participants to develop capabilities over time, and as climate-related risks evolve.

In the US, the Federal Reserve is monitoring developments and participating in the NGFS, but some senior officials have indicated that it may not be appropriate to incorporate climate risk stress testing into the US Federal Reserve Bank's Comprehensive Capital Analysis and Review (CCAR).

In emerging markets, the International Monetary Fund is supporting these initiatives and intends to conducts its own work on macro-financial transmission channels of climate risks by improving its stress tests within its Financial Sector Assessment Program.[24] A key challenge in developing appropriate stress scenarios is the uncertain time horizons over which climate-related risks may be realized, and that their full impact may crystallize outside of many current business planning horizons. The UK and French exercises thus included a longer time horizon (30 years), broader geographic coverage of exposures and a sectoral/counter-party level modeling approach.

Finally, although mitigating climate-related risks through capital charges is generally a longer-term consideration,[25] supervisors, particularly in Europe, are exploring the inclusion of 'green supporting factors' or 'brown penalizing factor' for regulatory capital in order to assist in aligning portfolios with the transition to a net zero carbon economy.[26] At present, the focus is very much on Pillar 2 capital requirements, through stress testing and the supervisory risk and evaluation process (SREP).

There is no consensus amongst banking regulators as to whether it is appropriate to include ESG adjusting factors in Pillar 1 capital calculations in view of potential consequences for financial stability, in addition to unique challenges presented by climate risks, e.g., longer time horizons, lack of empirical evidence, data and modelling capabilities.

The EU Commission has advanced the European Banking Authority's work on possible risk-weighted adjustment through a green supporting factor – effectively capital relief – could incentivize the decarbonization of banks' balance sheets and foster more green investment.[27] Similar considerations are ongoing in relation to insurers' Pillar 1 requirements in order to determine how to incorporate a more forward-looking view into the capital calibration of natural catastrophe risk.

Separately, China is thought to be lowering risk weights for green assets, noting positive evidence to support such an approach based on performance of the green bond market.

With incoming principles at the global level via the Basel Committee on Banking Standards' recommendations for climate risk management and supervision, to which State Street responded in January, we expect supervisory focus to increase in 2022 and beyond.

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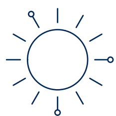
Encouraging market-based initiatives to scale up voluntary carbon markets

Market-based initiatives in relation to voluntary carbon markets have gained traction in recent years and will continue to be prominent as global finance leaders seek to scale-up voluntary markets under the Sustainable Markets Initiative (SMI).[28]



The first and largest carbon market is the EU Emissions Trading System, established in 2005, and is premised on the 'Cap and trade' principle.[29]

Besides the EU emissions trading system (EU ETS), national or sub-national systems are already operating or under development in Canada, China, Japan, New Zealand, South Korea, Switzerland and the US.

Hence, there is ongoing work to assess the viability of an international carbon market via the International Carbon Action Partnership.[30] Furthermore, as part of the European Green Deal, the EU Commission also proposed a carbon border adjustment mechanism (CBAM) in 2019, but this is yet to make its way through the legislative process.

At the global level, the IMF is expected to propose the creation of an international carbon price floor arrangement that complements the Paris Agreement and is launched by the largest emitters, anchored on a minimum carbon price and designed pragmatically.[31]

Once having reached critical mass, active and liquid carbon markets can become an interesting playing field for institutional investors and could at times be an important component in net zero strategies. While at an early stage, this is an area that should be monitored closely.

Key takeaways for financial market participants

- Disclosure standards and priced carbon markets are fundamental mechanisms that will enable market participants to properly account for climate risk and make decisions accordingly.

- There is now a plausible path toward a single, global disclosure standard for sustainability after the formation of the ISSB in the fall of 2021. However, the process of convergence remains extremely challenging and the complexity of agreeing on terms, definitions, and frameworks that continue to evolve should not be underestimated.

- Policy makers should take care to ensure any regulatory regime can be applied across the investment spectrum. That means regulation should not solely be relevant to active, heavily research-driven, concentrated stock selection strategies. Policy frameworks need to lend themselves to index-tracking and asset classes such as cash.

- ESG data providers, index providers, and rating agencies all have a part to play and we would expect to see regulatory action coming in this space as well.

- With so many open questions across ESG, it is understandable that some in the industry may be looking for international agreement on rules around standards, frameworks, and taxonomies to determine their actions. But this may be a mistake. ESG is a fluid area and those who remain passively on the sidelines risk losing time and insight by not determining their own approach (which most likely will be required regardless of regulatory frameworks). In other words, don't wait for "regulatory perfection" as this might never come and because of the nature of ESG, those rules may involve a high degree of discretion.

- We identify a number of "no regret" moves for participants to consider in the current and evolving regulatory landscape:
  - Be proactive and determine your own approach to sustainability. For example, investors should think about their own sustainable investment policies and determine what environmental or social objectives they want their portfolios to consider, and engage with their managers to realize them.
  - Adopt disclosure frameworks that are widely supported such as TCFD. This will build familiarity and expertise with sustainability disclosure.
  - Build internal resources and develop a knowledge base around sustainability that will help inform and develop strategic thinking.
  - Stay on top of global regulatory developments across regions.
  - Consider partnering with others in the industry to access expertise in areas you may be lacking.

Endnotes

1. The 2030 Agenda for Sustainable Development was adopted by all United Nations Member States in 2015, defining 17 Sustainable Development Goals (SDGs). The UN estimates the gap in financing to achieve the Sustainable Development Goals (SDGs) at $2.5 trillion per year in developing countries alone; it is also estimated that achieving the SDGs could open up $12 trillion of market opportunities (see *UN Secretary General's 2019-2021 Roadmap for financing the 2030 Agenda for Sustainable Development*). The UN Biodiversity Finance Initiative (Biofin) also estimates that the needs of financial flows to protect nature run up to $440 billion.

2. For the purposes of this paper, 'prudential rules' means regulatory requirements applicable to banks and insurers.

3. For 2017 TCFD recommendations, **https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf**. Note: TCFD launched a short consultation to update its 2017 recommendations in June 2021, but for the purposes of this paper, our comments in respect of the TCFD framework do not take into account the proposed revisions to the 2017 TCFD recommendations.

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15. Green Finance Institute. "UK Taxonomy-GTAG." **https://www.greenfinanceinstitute.co.uk/uk-taxonomy/**. Monetary Authority of Singapore. "Industry taskforce proposes taxonomy and launches environmental risk management handbook to support green finance." January 28, 2021. **https://www.mas.gov.sg/news/media-releases/2021/industry-taskforce-proposes-taxonomy-and-launches-environmental-risk-management-handbook**

16. World Bank Group. *Developing a National Green Taxonomy: A World Bank Guide*. June, 2020.

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22. Kevin Stiroh, co-chair of the TFCR, clarified in a speech on 14 October 2020 that the TFCR "does not currently have a view on potential prudential treatments or supervisory expectations related to the mitigation of climate-related financial risks" and that it is following a "gradual and sequential approach from a banking supervisory perspective, with a current focus on understanding climate risk transmission channels, as well as methodologies for measuring and assessing these risks." It intends to "complete these fundamental research initiatives by mid-2021."

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25. As noted, for example, in Network for Greening the Financial System. *Guide for Supervisors Integrating Climate Related and Environmental Risks into Prudential Supervision*. 2020 and Basle Committee on Banking Supervision. Climate Related Financial Risks: A Survey on Current Initiatives. April 2020.

26. EBA. Action Plan on Sustainable Finance outlines EBA's approach for delivering advice to the EU Commission on key metrics, risk management, scenario analysis, and adjustments to risk weights. 2019.

27. The EU Commission has intended for the EBA to deliver its final advice by 2025, but this has been brought forward to 2023.

28. Sustainable Markets Initiative. "Building a Sustainable Future." **https://www.sustainable-markets.org/**

29. A cap is set on the total amount of certain greenhouse gases that can be emitted by the installations covered by the system. The cap is reduced over time so that total emissions fall. Within the cap, installations buy or receive emissions allowances, which they can trade with one another as needed. The limit on the total number of allowances ensures that they have a value. After each year, an installation must surrender enough allowances to cover fully its emissions, otherwise heavy fines are imposed. If an installation reduces its emissions, it can keep the spare allowances to cover its future needs or else sell them to another installation that is short of allowances. See European Commission. "EU Emissions Trading System." Climate Action. **https://ec.europa.eu/clima/policies/ets_en**

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