P.R.I.M.E. Finance

Panel of Recognized International Market Experts in Finance

Sustainable finance – a supervisory and central bank perspective

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Sustainable finance: definition

- Environmentally sound financing….
- ….favouring sustainable and inclusive growth, “meeting society’s long-term needs for innovation and infrastructure, and accelerating the shift to a low-carbon and resource efficient economy” (EU HLEG on Sustainable Finance, interim report)
- Reflecting financial risks from carbon exposure
- Twin adoption of the 2030 Agenda for Sustainable Development and the Paris Agreement in 2015

Note our language: ‘environ(ne)ment’ / ‘milieu’ / ‘Umgebung’ implies a distance between ourselves and what is around:
an anthropocentric view of the interconnected universe

Sustainable Development Goals

Agenda 2030, UNGA Resolution 70/1, 21 October 2015

Amending EU law for sustainability

“Reaching our Paris agreement goals requires no less than a transformation of the entire financial system, its culture, and its incentives.”
Valdis Dombrovskis, Jyrki Katainen, preface to HLEG Report

- EU High-level Expert Group Report
- Recommendations:
  - An EU ‘sustainability taxonomy’ “identif[ying] under which conditions or criteria any given investment or financial product will contribute to the EU’s sustainability objectives”
  - Developing official European sustainability standards for financial assets, starting with ‘green bonds’
  - Extending the time horizons of investment and bring greater focus on environmental, social and governance (ESG) factors into investment decisions
  - ESG (Environmental, Social & Governance) disclosure by firms and financial institutions

- Amending Capital Requirements Directive

  European Parliament proposal Article 84a amendment to CRD-V

Article 84a Climate-related risks
(proposed by the European Parliament as an amendment to CRD IV)

1. [Supervisory] authorities shall ensure that policies and processes for the identification, measurement and management of all material sources and effects of climate-specific risks are implemented.

2. For [these], the [bank/investment firm] shall identify the following: a) the risks to which [it] is exposed in the short, medium and long terms; b) a description of significant concentrations of credit exposures involving carbon-related assets, if these exposures are material; c) a description of the impact of the climate-related risks on [its] business, strategy and financial planning, if these risks are material and financial; d) a description of the processes which [it] uses to identify, assess and manage climate-related risks; e) the parameters which [it] used to assess the impact of short-, medium- and long-term climate-related risks on lending and financial intermediary transactions, if these risks are material.

3. The [European Banking Authority] shall issue guidelines to specify: a) what is meant by a short-term, a medium-term and a long-term time frame; b) what is meant by specific climate related problems which may arise in the short, medium or long term and which could have a material, financial impact on the institution; c) what is meant by physical risks and transition risks; d) what is meant by the processes used to determine which risks could have a material, financial impact on the institution; e) what is meant by a carbon-related asset. The EBA shall publish these guidelines by ... [two years after the entry into force of this Directive]

Agreed text in the trilogue - 1

Article 98 - paragraph 7c – CRD

"7c. The EBA shall assess the potential inclusion in the review and evaluation performed by competent authorities of environmental, social and governance risks (ESG).

For the purpose of subparagraph 1, the EBA assessment shall comprise at least the following:

(a) the development of a uniform definition of ESG risks including physical risks and transition risks. The latter shall comprise the risks related to the depreciation of assets due to regulatory changes;

(b) the development of appropriate qualitative and quantitative criteria for the assessment of the impact of such risks on the financial stability of institutions in the short, medium and long term. This shall include stress testing processes and scenario analyses to assess the impact of ESG risks under scenarios with different severities;

(c) the arrangements, strategies, processes and mechanism to be implemented by the institutions to identify, assess and manage ESG risks;

(d) the analysis methods and tools to assess the impact of ESG risks on lending and financial intermediation activities of institutions.

The EBA shall submit a report on its findings to the Commission, the European Parliament and the Council by [two years after entry into force of this regulation].

On the basis of the outcomes of its report, the EBA may, if appropriate, adopt guidelines for the uniform inclusion of ESG risks in the supervisory review and evaluation process performed by competent authorities."

Agreed text in the trilogue - 2

"Article 449a CRR

Disclosure of ESG-related risks

"By way of derogation from Articles 433a (1) (a), 433a(2)(a) and 433c(1)(a), only large institutions which have issued securities that are admitted to trading on a regulated market of any Member State, as defined in point (21) of Article 4(1) of Directive 2014/65/EU, shall disclose information on ESG-related risks, physical risks and transition risks as defined in the report referred to in Article 98(7c) of Directive 2013/36/EU from ... [3 years after entry into force of this Regulation].

For the purpose of the first subparagraph, the information shall be disclosed annually the first year and biannually the second year and thereafter."

Information obtained thanks to Peter Simon, MEP

Agreed text in the trilogue - 3

It opens the door for a so called "brown penalizing factor" or/and "green supporting factor"

"**Article 501da CRR**

The EBA, after consulting the ESRB, shall assess on the basis of available data and the findings of the High Level Expert Group on Sustainable Finance of the Commission whether a dedicated prudential treatment of assets exposed to activities associated substantially with environmental and / or social objectives, in the form of different capital charges, would be justified from a prudential perspective. In particular, EBA shall investigate:

(i) methodological options for assessing exposures of asset classes to activities associated substantially with environmental and/or social objectives;

(ii) specific risk profiles of assets exposed to activities which are associated substantially with environmental and/or social objectives;

(iii) risks related to the depreciation of assets due to regulatory changes such as climate change mitigation;

(iv) the potential effects of a dedicated prudential treatment of assets exposed to activities which are associated substantially with environmental and/or social objectives on financial stability and bank lending in the Union.

The EBA shall submit a report on its findings to the Commission, the European Parliament and the Council by [two years after entry into force of this regulation].

On the basis of this report, the Commission shall, if appropriate, submit to the European Parliament and the Council a legislative proposal."

Frank Elderson, Executive Director of De Nederlandsche Bank

Prudential standards for ecological reasons?

Mark Carney, Governor of the Bank of England

- Is this an acceptable way of reforming prudential standards?
- Yes, for several reasons:

1. Need to prepare for a deep reduction in value of current investments once oil becomes obsolete (like tobacco in the past and the meat ‘industry’ in the future); ‘tragedy of the commons’; Mark Carney: Breaking the tragedy of the horizon – climate change and financial stability
2. Physical risk; transition risk; ‘climate change as a driver of financial risk’
3. As long as the prudential character of standards is maintained, making these also serve other purposes that we, as a global or European society have adopted, is acceptable, even laudable

DNB in the vanguard

- Waterproof? An exploration of climate-related risks for the Dutch financial sector (2017)
- Inauguration of the Network for the Greening of the Financial Sector – January 2018 – voluntary organization with a charter *(see the next slide)*
- Dutch financial sector also faces environmental and social risks, 21 January 2019: Report Values at Risk?

Network for the Greening of the Financial Sector

The Central Banks and Supervisors Network for Greening the Financial System (NGFS) is a group of Central Banks and Supervisors willing, on a voluntary basis, to exchange experiences, share best practices, contribute to the development of environment and climate risk management in the financial sector, and to mobilize mainstream finance to support the transition toward a sustainable economy. Its purpose is to define and promote best practices to be implemented within and outside of the Membership of the NGFS and to conduct or commission analytical work on green finance.

Wider SDG-related issues & finance - 1

- fresh water

[Dutch financial institutions have invested at least EUR 97 billion in businesses operating in extremely water-scarce regions. If scarcity turns into shortages, business facilities' operations could risk being blocked or restricted. Likewise, governments could regulate water use more strictly. As a result, financial institutions' outstanding loans or investments could be exposed to increased risk.]

- raw material scarcity

[Dutch financial institutions have invested around EUR 56 billion in businesses that depend on the most critical raw materials. Scarcity or geopolitical factors could increase their supply risks, however, which, in turn, could affect financial institutions that invest in businesses which depend on such raw materials]

- human rights

[Human rights violations must also be taken into consideration from a risk management perspective, however. Media reports on human rights controversies can expose financial institutions to reputational risk. For these and other reasons, the study stresses the importance of (..) guidelines (which aim to counter human rights malpractices).]

Wider SDG-related issues & finance - 2

- biodiversity loss…

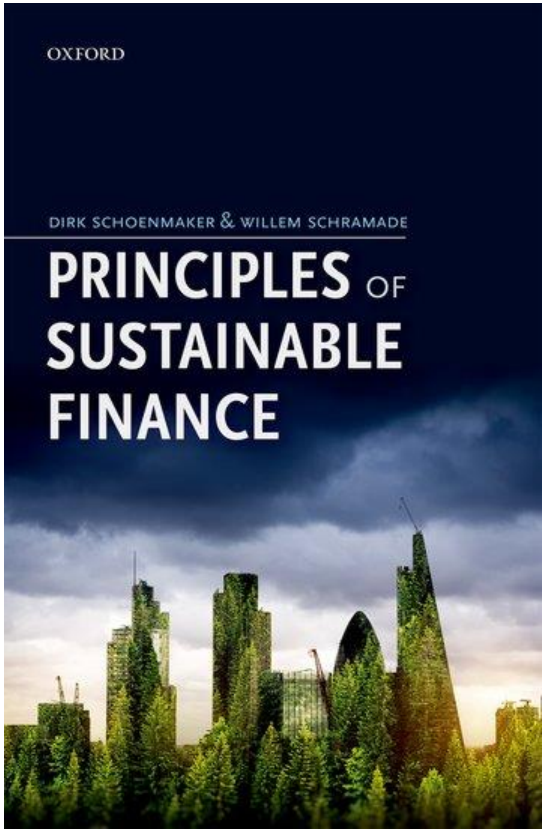
[Reduced pollination and declining resilience of ecosystems expose investments and lending in the agricultural sector to growing risks.]

- **"Integrating sustainability ambitions into the operational management of financial institutions**

According to the present study, all financial institutions we surveyed formulate sustainability policies, and a majority commit themselves to standards like the Sustainable Development Goals or the principles of the United Nations Global Compact. They also issue sustainability reports on a regular basis.

A minority of the 25 Dutch financial institutions we surveyed integrate sustainability ambitions into their operational management. A mere 36% of the surveyed institutions have set concrete indicators and targets as part of their sustainability policies, while only one out of five evaluate the impact of their efforts. Our findings emerged from a study among the Netherlands' largest pension funds, insurance firms and banks.

Financial institutions expose themselves to reputation risk if they fail to live up to expectations or to deliver on their promises. This means it is important that they set up their operational management so as to provide adequate safeguards. For many financial institutions, logical next steps will be setting clear indicators and targets, monitoring performance and measuring impact."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