Informal ECOFIN meeting on 22 April Agenda item 'Sustainable finance'

Stocktaking note by DG FISMA services

Introduction

There is growing focus on green, or more broadly, sustainable finance, both in financial markets and in the international political arena. It is part of comprehensive EU actions to reduce CO_2 emissions, tackle climate change in line with the Paris Climate Agreement (COP21) and transition to a low-carbon, climate-resilient and resource-efficient economy. The EU has set ambitious climate policy goals by agreeing to cut its greenhouse gas emissions by at least 40% by 2030, compared with 1990 levels. Achieving those emission reduction goals requires substantial investments and the mobilisation of the necessary financing from public and private sources. The EU has committed to spend at least 20% of its budget on climate-related action. The EU has also used its powers to propose legislation to put forward important measures and requirements regarding energy efficiency[1] and the use of renewables[2]. Climate and energy initiatives at European Union level are accompanied by national initiatives at Member State level (e.g. France, Sweden and The Netherlands) and some market-led initiatives in support of sustainable finance.

The question arises as to how the financial policy framework can contribute to an orderly transition. There are 2 main dimensions to this issue which will be briefly considered in this note:

1. The first dimension concerns the minimisation of financial instability risk linked to climate change and the transition.
2. The second dimension relates to creating a supportive policy environment that facilitates an efficient reorientation of investment towards environmentally sustainable applications.

Interactions exist between these two dimensions as, for instance, natural disasters may lead to significant financial impacts for investors while a timely reorientation of investments towards environmental sustainability would reduce transition risks.

[1] In 2012, the EU Energy Efficiency Directive (EED) 2012/27/EU was adopted which aims at ensuring the achievement of the EU's 20% target on energy efficiency increase by 2020. The EED brings forward binding measures to increase energy efficiency along the energy supply chain, from transformation to distribution and consumption.

[2] The Renewables Directive (2009/28/EC) requires that the EU fulfils at least 20% of its total energy needs with renewables (solar, wind, hydro) by 2020 (to be achieved through the attainment of individual national targets) as part of its drive to cut emissions of carbon dioxide. All EU countries must also ensure that at least 10% of their transport fuels come from renewable sources by 2020.

1. Financial stability considerations

Can climate change and the transition to a low-carbon economy compromise the stability of the financial sector through losses and a sudden revaluation of assets held by financial institutions? Institutional investors have started revisiting their investment strategies in carbon-intensive assets and for sector exposed to potentially stranded assets (notably for fossil fuel firms and energy companies). Recently, some EU institutions and central banks of some EU Member States (e.g. United Kingdom, France, The Netherlands and Finland) have begun to investigate how and to what extent climate change implications could affect the financial sector or even be a source of systemic risk to it. Financial stability risks may arise from environmental change events themselves (such as natural disasters) or events related to the transition process to a low-carbon economy including policy interventions, technology breakthroughs and disruptive business models.

At European level, some relevant developments in this respect include the following:

- In February 2016, the European Systemic Risk Board (ESRB) published the report of its Advisory Scientific Committee on potential implications of a disorderly transition to a low-carbon economy on the stability of financial markets proposing enhanced disclosure and incorporating climate-related prudential risks into stress-tests as policy responses to mitigate risks for the financial system.
- On 27 March 2014, the Commission adopted a legislative proposal for new rules on occupational pension funds (IORPs) that requires these funds to assess in their risk evaluations emerging risks relating to climate change, use of resources and the environment. The rule regarding climate impacts is in fact not consensual. Trilogues started in February 2016.

Carbon stress tests are an important risk management tool in this context. They can help measure the impact of environmental factors on financial institutions, investors, and other financial market participants. Carbon stress tests can help establish, inter alia, the exposure of EU financial institutions to fossil fuel risks. Work in this direction has started in relevant European supervisory authorities and useful related public and private initiatives exist globally. However, the complexity of designing appropriate test scenarios and of collecting data necessary for conducting the tests should not be underestimated, especially given the lack of convergence in defining what is green. Further analysis and work is needed in this area.

2. Financial policy to mobilise investment for sustainable solutions

The second issue is whether and how financial policy framework can facilitate transition by mobilising capital or reorienting investment towards environmentally sustainable applications. UNCTAD estimates that transition to the infrastructures and technology consistent with achieving the sustainable development goals will entail annual investment needs of $ 5-7 trillion to 2030. Aligning investments to sustainable development encompasses a number of issues, notably the need for common definitions and standards (what is green and how to measure it?), disclosure and transparency requirements to improve investors' confidence as well as greater coherence of EU policies, regulatory measures and EU budgetary support to mobilise private finance for green investment.

2.1 Convergence of definitions and standards (particular focus on green bonds)

The absence of a commonly agreed definition of what is 'green', and of broadly accepted methodologies to support comparability, is a key stumbling-block to green finance. These issues have particular relevance in the fast-developing market for green bonds but also for broader assessment of 'greenness' of assets. Industry-led voluntary standards such as the Green Bond Principles, used inter alia by Multilateral Development Banks for their green bond issuances, are an important step in the direction of convergence. The Green Bond principles focus primarily on the safeguards regarding "use of proceeds" by issuers. International or pan-European definitions, standards and market conventions may be needed to enhance investors' confidence in investment solutions carrying a "green" label, to measure impact and monitor progress in achieving sustainable policy objectives.

Issuance of green bonds increased from less than EUR 1 billion on a yearly basis before 2012 to EUR 52 billion in 2015 (global figures) showing increasing investor demand. The still nascent market is currently dependent on a number of public financial institutions, notably Multilateral Development Banks such as EIB, EBRD and the World Bank, to underwrite the issuance of these bonds, however issuance by private corporates and municipalities is increasing. Since there is no commonly agreed definition or standard for what is 'green', issuers may use the attractiveness of this label to 'greenwash' bonds. Another concern is that a green label does not generate additional funds for projects which would have been funded in any case. Counterbalancing these risks is the reputational risk for investors that portray themselves as green or, on purpose or not, invest in green-washing bonds. To provide assurance on the integrity of green bond issuances, some issuers of green bonds have taken on an additional reporting burden on the use of proceeds, in line with sustainability objectives.

Essentially, policy recommendations aim to enhance market integrity and transparency. In the context of the Capital Markets Union (CMU), it is also important to avoid EU market fragmentation and other (new) barriers to capital movement which might develop due to isolated national legislative initiatives. Hence, the Commission continues to assess and support developments in Environmental, Social and Governance (ESG) investments and monitors the need for EU green bond standards, in line with the CMU.

Convergence of definitions and standards are also essential to address the chronic underinvestment in energy efficiency, which is one of the key areas for "green investing". In the EU, an estimated EUR 108 billion need to be invested annually in energy efficiency measures and yet, present investment flows are sub-optimal, with volumes below half of these requirements. In that context, Financial Institutions and experts need to cooperate in order to define a common framework for energy efficiency investment underwriting procedures, including the procedural and technical requirements related to origination, structuring, contracting, adjudication, financing and refinancing of energy efficiency investment transactions.

2.2 Disclosure by issuers and institutional investors

Disclosure and transparency about exposure to environmental and climate-related risks of companies and bond issuers are becoming increasingly relevant for private and institutional investors and facilitate market-led impetus towards sustainable investments. Informed long-term investment decisions require access to information about compliance with environmental standards and physical environment scenarios which may have an impact on the risk/return profile of such assets. Several policy initiatives are underway to evaluate the possible implications of environmental scenarios on assets, investor portfolios and system resilience.

Considerable work has been undertaken at European level with respect to disclosure and reporting by large issuers and by institutional investors. Relevant recent measures and actions addressed to issuers include:

- The 2014 EU Directive on the disclosure of non-financial and diversity information. This requires certain large companies to disclose information on policies, principal risks and outcomes relating to environmental matters, among other issues. The European Commission is currently working on preparing non-binding guidelines foreseen for end 2016. To gather input, a broad consultation was launched on 15 January 2016 closing on 15 April.
- The Shareholder Rights Directive, currently under negotiation, aims to increase transparency in the investment chain and to set out a framework for better engagement between companies and their shareholders.

The Commission services have completed, or are currently engaged in, the following work on integration of environmental and sustainable considerations in institutional investor policies:

- In March 2015, DG CLIMA published a study on 'Shifting private finance towards climate-friendly investments' which developed a list of recommendations to address barriers to and mobilise institutional investors for climate investments, both in the EU and globally.
- In December 2015, DG JUST launched a public consultation on long-term and sustainable investments and to which extent institutional investors take Environmental, Social and Governance (ESG) issues into account when making their investment decisions.
- In December 2015, DG ENV published a study on Fiduciary Duty entitled Resource Efficiency and Fiduciary Duties of Investors, which examines the state of fiduciary duty legislation at the EU level and in five selected member states.
- The Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation has deferred decision on the integration of environmental and sustainable considerations into these disclosures until the scheduled 2018 review.

2.3. Putting a price on carbon

Carbon pricing leads to a differentiation in return profiles between those investments that are targeted and those that are not. Thereby, carbon pricing can align investors' incentives with climate objectives. Globally, an increasing number of countries are putting a price on greenhouse gas emissions through carbon taxes or emission trading schemes. Some countries

are dissuading investments in certain carbon-intensive assets through regulation, thus putting an implicit price on carbon.

In 2005, the EU launched the Emissions Trading System (ETS) which is the EU's flagship climate policy to reduce greenhouse gas emissions at the least cost whilst stimulating investment in the low-carbon economy. The introduction of the Market Stability Reserve, in operation from 2019 onwards, is expected to strengthen the carbon price signal. The Commission presented in July 2015 a legislative proposal to revise the EU ETS for the period after 2020 as a first step in delivering on the EU's target to reduce greenhouse gas emissions by at least 40% domestically by 2030 in line with the 2030 climate and energy framework and as part of the new global climate deal adopted in Paris. The revised EU ETS will also provide funding mechanisms to help industry and the power sector make low-carbon and energy modernization investments.

3. Major international initiatives

The European Union is also involved in the various work streams and contributes to on-going work at international level (i.e. G20 and FSB initiatives). As developing sustainable finance is a global concern, coordinated and coherent EU input in respect of shaping the international framework on sustainable finance would need to continue and even intensify in the future. The following sections describe already launched and on-going EU initiatives in the context of sustainable finance and the state of play of work at international level.

3.1. FSB industry-led Task Force

In April 2015, the G20 Finance Ministers and Central Bank Governors requested the Financial Stability Board (FSB) to review how the financial sector can take account of climate-related issues. On December 4, 2015, the FSB established the industry-led Task Force (Task Force on Climate-related Disclosures, TFCD) to make recommendations for improving principles and practices for voluntary disclosures. The Task Force is composed of a diverse group of experienced members (including banks, insurers, energy utilities and other market participants from a variety of industries and regions) and is led by Mr Bloomberg as Chairman.

The Task Force plans to deliver two reports. The first report, already published on 31 March, looks at current levels of disclosure and outlines the scope of the work to be done. In order to engage with a broader array of interested stakeholders the Task Force launched a public consultation on 1 April (with a deadline of 1 May). The second report, to be delivered by the end of the year, will create a set of guidelines for voluntary company disclosures by identifying leading practices to improve consistency, accessibility, clarity, and usefulness of climate-related financial reporting.

The Commission follows closely the work of the FSB Task Force and will take their recommendations into account when preparing its non-binding guidelines on non-financial reporting. The FSB work is complementary to the G20 Green Finance Study Group that was established by the Chinese Presidency.

3.2 G20 Green Finance Study Group

The 2016 Chinese G20 Presidency initiated a Green Finance Study Group (GFSG) co-chaired by China (Public Bank of China (PBOC)) and the UK (Bank of England), with support from the United Nations Environment Program (UNEP) as the secretariat. The G20 work is complementary to the work undertaken within FSB.

The GFSG agreed that the objective of the group is to identify institutional and market barriers to green finance and, based on country experiences and best practices, analyse (voluntary) options on how to enhance the ability of the financial system to mobilize private green investment, thereby facilitating the green transformation of the global economy. To deliver this objective, the GFSG agreed to address a set of interrelated challenges across five research areas, including (1) greening the banking system, (2) greening the bond market, (3) greening institutional investment, (4) risk analysis and (5) measuring progress.

The work of the GFSG is ongoing. Barriers identified so far have been categorized into externalities; maturity mismatches (e.g. a particular issue for green investments with long payback periods); information asymmetry with inadequate information increasing search costs for green investments; and inadequate capabilities to mitigate common barriers.

Emerging options that are considered are related to internalising externalities through common definitions, maturity alignment through the issuance of green bonds, improvement of disclosures to facilitate the take-up of green investment (work done by FSB). Capacity building could be enhanced with the development of risk analysis tools, green ratings of financial products, and commonly agreed norms for defining green finance. Institutional investors' governance and transparency could be improved.

The group will deliver the G20 Report to the G20 Finance Ministers and Central Bank Governors in Chengdu during 23-24 July, and finally present the report for adoption at the G20 Summit in Hangzhou (4-5 September).

3.3 Energy Efficiency Financial Task Group (G20)

In November 2013, the Energy Efficiency Financial Institutions Group (EEFIG)[3] was established by the European Commission and the United Nations Environment Program Finance Initiative (UNEP FI). It created an open dialogue and work platform for public and private financial institutions, industry representatives and sector experts on how to overcome the challenges of obtaining long-term financing for energy efficiency. EEFIG has since its creation engaged 120 active participants from 100 organizations to deliver a clear and unambiguous message. The EEFIG work and its report[4] have inspired the work of G20 that has created the Energy Efficiency Task Group, which has defined the energy efficiency investment principles, and investor statements[5]. The work will significantly contribute to the global discussion on standardisation for low-carbon economy investments.

[3] http://www.eefig.com/

[4] "Energy Efficiency – the first fuel for the EU Economy; How to drive new finance for energy efficiency investments", EEFIG, 2015

[5] http://www.unepfi.org/fileadmin/documents/EnergyEfficiencyStatement.pdf