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Building a sustainable finance ecosystem

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The themes of environmental, social and governance (ESG) and sustainable finance are featuring increasingly within the conventional finance sectors - giving rise to much confusion as to what these terms encompass. Sustainable finance is essentially a movement to address a perceived inadequacy in the current economic model by requiring private actors to acknowledge the importance of factors and outcomes, other than the pursuit of profit in their business models.

Environmental, social and governance can be said to be the three sub-themes encapsulated by sustainable finance. They in turn encompass matters as wide ranging as carbon regulation, health and safety, financial inclusion, corruption and bribery to board diversity.

Sustainable finance and ESG require a company to take a more holistic approach to its business by taking responsibility for ESG issues arising from its operations. This often means that private actors are being asked to espouse standards beyond what is required of them by law. There have been many studies that demonstrate a better economic outcome for business models that incorporate ESG.

The **17 objectives** of sustainable development have been set out by the United Nations in its creation of the "Sustainable Development Goals". Sustainable development is described as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs".

Sustainable finance in the EU

EU regulators have taken up the sustainable finance mantle. They argue that the current way of doing business is unsustainable and will not withstand being subjected to market shocks arising from the materialising of environmental, technological or related risks.

Led by Mark Carney, Governor of the Bank of England, the EU has established a European Union **Action Plan** for financing sustainable growth which has 10 initiatives under its umbrella. The overarching aims of the Action Plan are to redirect capital towards sustainable and inclusive investment, manage financial risks arising from environmental and social issues and to increase transparency and long-term decision making.

While their view of sustainability is broad, it has been accepted that the need to address environmental issues is more pressing – given the carbon reduction targets placed upon signatory nations to the 2015 Paris Climate Agreement and the 40 percent EU target to reduce greenhouse gas emissions by 2030.

It was felt that in order to meet these objectives, there was need for the production of a taxonomy for "green activities" around which financial products could confidently be built, marketed and sold within the EU as green products. The criteria are likely to require that the activity meets a technically specified environmental objective and does not significantly harm any other environmental objective. Activities should also meet minimum social safeguards.

The taxonomy is being prepared by a Technical Expert Group which is looking at other similar classification systems. Originally intended to be released at the end of 2018, the EU taxonomy is currently expected this year.

The classification process, once settled, will:

- apply within the EU and to assets being marketed within the EU;
- provide consumers with clarity when making their investment decisions;
- drive global best practice in the sector going forward; and
- may be linked to regulatory risk weightings which incentivise green activities or penalise undesirable activities in order to address mis-pricing.

The incorporation of sustainability into financial advice, creation of sustainability benchmarks and non-financial disclosures are some of the other nine initiatives being undertaken under the auspices of the Action Plan. The last of these has been implemented by the EU Non-Financial Reporting Directive which requires "large companies to publish regular reports on the social and environmental impacts of their activities". It is expected these requirements will become universally applied over time.

It is worth noting that although the UK has not participated in much of the Action Plan process, certain related directives have already been incorporated into UK law and, following an exit from the EU, it is likely that parallel frameworks will be adopted by the UK over time.

'E' is for environment

Much of the current focus within ESG remains on the "E" for Environment. Gains were initially sought through the targeting and realignment of the energy and transport sectors with decarbonising strategies. These strategies have been largely successful given, amongst other things, the establishment in the last decade of two mainstream sectors in the UK and globally: renewable energy (comprising solar and wind and other "clean" forms of technology); and more recently the electric vehicle market.

Both of these sectors owe their success to a combination of supportive incentive frameworks and penalising legislation such as the Ultra-Low Emission Zone implemented in London, which has resulted in many transport businesses fully overhauling their fleets in order to comply with the new standards.

Transport and energy were the first sectors to fall within the purview of regulators because they are both relatively high carbon producing in nature, and they are easy to regulate centrally. The next targets are buildings and industry, which are responsible for 25 percent and 40 percent of total energy use in the EU respectively. However, the reduction of carbon emissions from these industries is proving more difficult to influence and we can expect government intervention on these fronts in the future.

The financial markets

The finance industry's response to sustainable finance has been varied and largely self-directed. The rise in popularity of alternative funding models over the last decade – such as ethical finance, impact investment and patient capital – are all responses to the sustainable finance theme. While these are not particularly mainstream ideas, the introduction of the **Equator Principles** in the project finance world marked a clear shift towards a more holistic approach in commercial finance. An explanation may be that these principles apply to project finance where the involvement of public bodies tends to result in a less aggressive and more long-term approach.

It has been interesting to witness the pressure from investors – including sovereign wealth funds, pension funds, private equity and family offices – as they increasingly place ESG in some form or another on the agenda when considering their investments. Perhaps in response to this investor demand, ICMA, the International Capital Market Association, introduced voluntary frameworks for the issue of bonds which fit within the transition agenda.

These include the Green Bonds Principles, the Social Bond Principles and the Sustainability Bond Guidelines. Alongside this, the Climate Bonds Initiative is solely focused upon "mobilising the $100 trillion bond market for climate change solutions" and claims that $167.3 billion worth of green bonds were issued in 2018. Many green bond issuances have been by sovereigns.

Inspired by this, the Loan Market Association recently issued its own Green Loan Principles and Sustainability Linked Loan Principles as guidance to lenders wishing to bring credible "green loan" products into the market. The green loan market is still nascent, but it is espoused by several market players such as ABN Amro and ING to Barclays, Lloyds and HSBC. Many of these institutions have raised green bonds on the markets and made public ESG commitments. Each has taken a slightly different approach to the way in which they market their strengths and have created different green loan products for the commercial real estate and retail market.

ESG in the UK

To achieve the UK's target in the Climate Change Act 2008 to reduce UK carbon emissions by at least 80 percent compared to 1990 levels by 2050, the government published a Clean Growth Strategy in 2017 and a further report entitled "Accelerating Green Finance" which was delivered by the Green Finance Taskforce in 2018.

The Taskforce's recommendations include the promotion of UK green finance activities through a unified brand; implementing the TCFD recommendations (see below) and; building a green and resilient infrastructure pipeline. This suggests that its recommendations will be achieved through a mixture of legislature and regulation. A key recommendation was the proposal to set up a Green Investment Accelerator and other funding structures to promote commercial activities in this sector.

Carney has been particularly influential in the sustainable finance space. His "Breaking the tragedy of the horizons – climate change and financial stability" **speech** to the Lloyd's insurance market in September 2015 described the potential shocks to be mitigated against broadly as "liabilities" risk (physical and responsibility/litigation linked) and "transition" risk (re-pricing of carbon intensive financial assets). He also acknowledges that the Financial Stability Board and Bank of England routinely assess their financial modelling around a time-frame expanding to ten years at the most, thus giving little incentive at present to deal with anticipated but uncrystallised risks such as climate change.

His goal is to make the insurance and finance markets resilient and able to finance the transition to a future market. He proposes that the best way to achieve this is to develop frameworks which allow the markets to transition - such as the frameworks for the disclosure in relation to climate related exposures - so that the market can make its decisions based on transparent information.

The Taskforce on Climate related Financial Disclosures (TCFD) of which Michael Bloomberg is the chair, addresses the informational deficit to which the governor refers. The TCFD is a voluntary transparent and consistent disclosure framework which seeks the integration of climate-related financial risk disclosure into management processes.

If Carney can be described as an "activist regulator" then his counterpart in the legal sector has been the activist law firm "client earth". The firm has systematically placed pressure on pension funds to consider whether they are fulfilling their fiduciary duties if they do not take into account the effect of environmental and sustainability factors when assessing their investments. UK pension funds counter-argued that they were not mandated to consider any factors other than maximising the returns of their investments.

To clarify this confusion around fiduciary duties, the Department of Work & Pensions issued "clarifications" which state: "financially material considerations include (but [are] not limited to) environmental, social and governance considerations (including but not limited to climate change), which the trustees of the trust scheme consider financially material". Certain schemes are now required to update their Statement of Investment Principles and in due course they may be required to publish these statements.

Client Earth also wrote to the UK regulators to report breaches of section 172 of the Companies Act 2006 by oil and gas companies through their failure to adequately disclose climate change risks in their statutory strategic report. The requirement for a strategic report (which implements the Non-Financial Reporting Regulations, an EU Directive produced to implement the Action Plan) is meant to allow a company's members to assess how directors have performed their duty to promote the success of the company. It is expected that these challenges will lead to clarifications by the regulator and whatever the outcome of this, clearly activist pressure has had a considerable role in the concentration of minds on the themes of sustainability.

Influenced by corporate mandates or activist influences, or perhaps just responding to a collective call of conscience, the Church of England's £12 billion Endowment Fund has voted to divest its ownership of companies which do not back the Paris Climate Agreement. Many other funds are also doing the same, citing climate change and other financial risks as reasons. It should not be thought that these funds constitute the majority.

It is clear, however, that many major investors are considering their positions in relation to ESG matters. For some, making hard decisions to fully divest will not be palatable and they may alternatively decide to stay on boards in order to direct decisions toward transition. This choice will not be available in certain industries, such as tobacco, which are universally regarded as ethically problematic. It will certainly be interesting to see how these dilemmas are resolved.

Challenges to progress

Other challenges facing the progression of the sustainable finance agenda include the lack of consistency in ESG definitions, metrics and ratings. Even the existing green frameworks can be problematic because, possibly due to their voluntary nature, they avoid making value judgements on whether they can be used to support sectors, such as coal, which in the medium term will not assist in meeting the Paris Agreement targets. Many private operators have suggested that life would be much easier if there were simply a law which set out the new standards so that they need not articulate these ESG objectives for themselves.

Concluding thoughts

Most will be familiar with voluntary CSR initiatives embarked on by organisations, and with legislation enshrining what we think to be obviously accepted social principles - such as the Modern Slavery Act. These are manifestations of the sustainable finance agenda and demonstrate its breadth and variety. Clearly sustainable finance is not a new "product" but requires a new approach to doing existing things. As such a new cross-disciplinary sector is emerging to service this new approach which spans regulatory, finance, corporate, environmental and other specialisms.

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