

Faculty of Law, Economics and
Finance of the University of
Luxembourg

REGULATING SUSTAINABLE FINANCE IN THE DARK
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UNIVERSITÉ DU
LUXEMBOURG

BASED ON ZETZSCHE & ANKER-SØRENSEN, *REGULATING
SUSTAINABLE FINANCE IN THE DARK*, WORKING PAPER (2020)



FACULTY OF
ECONOMICS
AND FINANCE

1.

**BUSINESS &
HUMAN RIGHTS**

2.

**DEVELOPMENT
ECONOMICS &
DEVELOPMENT
FINANCE**

3.

**FINANCIAL
INCLUSION**

4.

**FINANCING THE
FIGHT AGAINST
CLIMATE CHANGE**

5.

**CLEAN ENERGY &
CLIMATE-NEUTRAL
ECONOMY**

6.

**GENDER,
INEQUALITY
AND CONFLICTS**

7.

**GREEN
SUPPLY CHAINS**

8.

**GREEN
ACCOUNTING**

9.

MIGRATION

10.

**RULE OF LAW
& DEVELOPMENT
COOPERATION**

11.

**SUSTAINABLE
GOVERNANCE
STRUCTURES
IN EUROPE**

12.

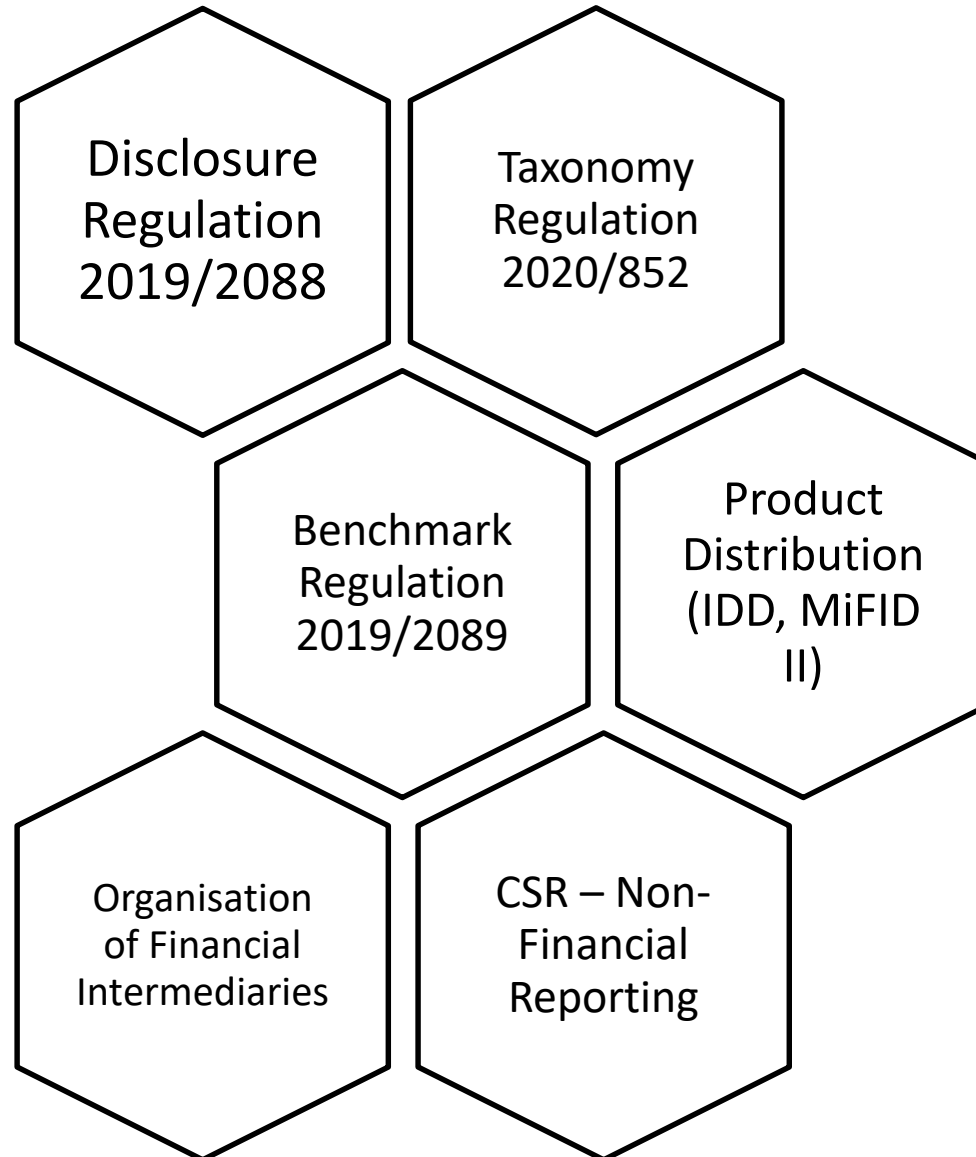
**SUSTAINABLE
FINANCE**

- I. Introduction
- II. SFAP of 2018: A Nudging Approach
- III. Green Deal & Renewed SF Strategy: What is to come?
- IV. Principles for Regulating in the Dark
- V. Conclusion

I. SFAP 2018

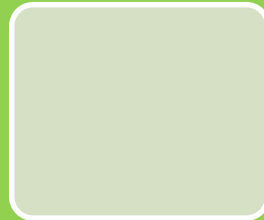
SFAP 2018 – six core initiatives

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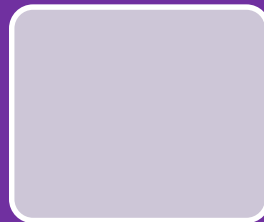




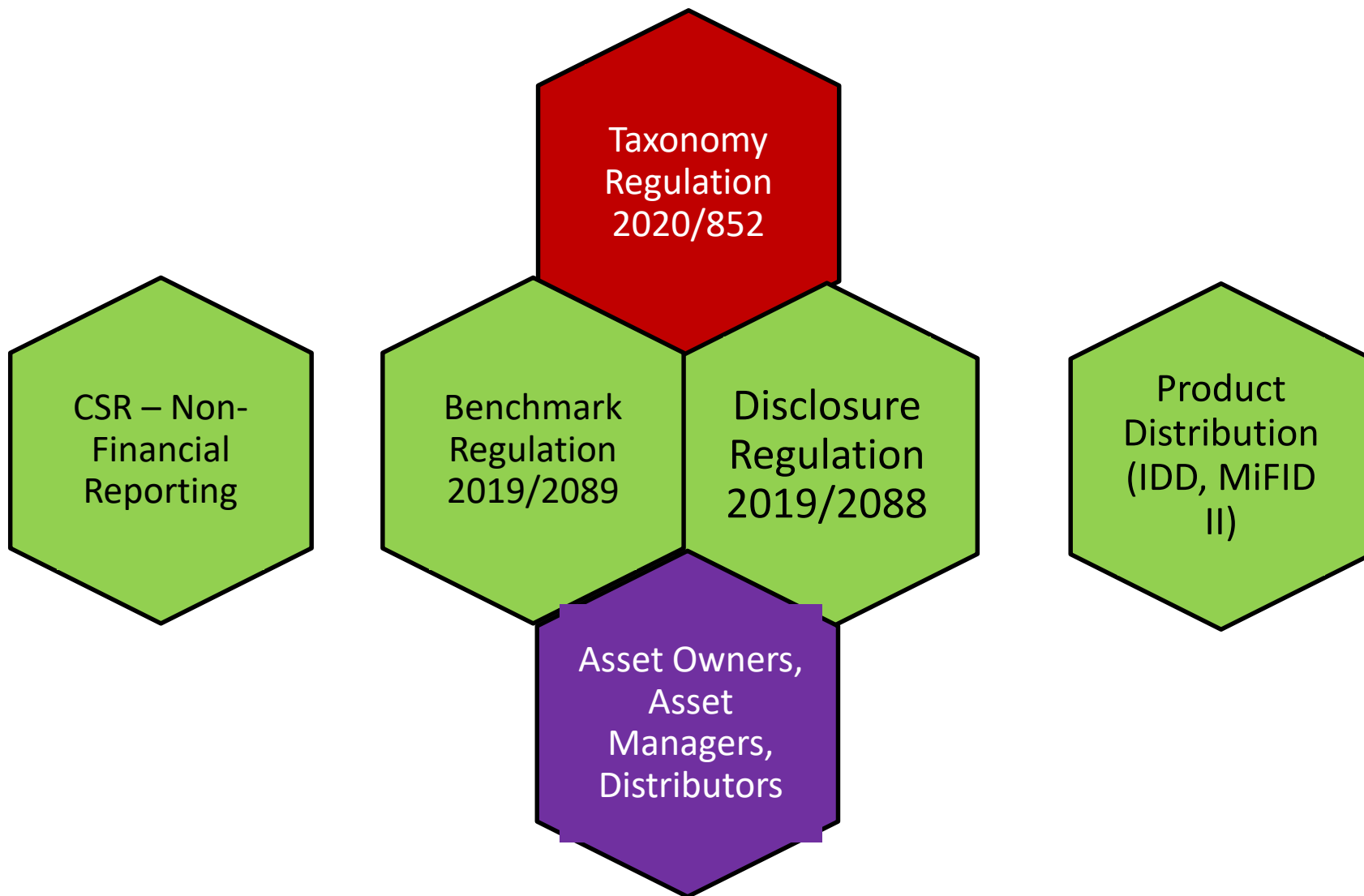
What is sustainable? (terminology)



Who is sustainable?



Acting sustainably

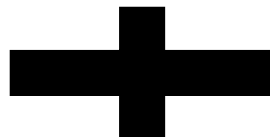


Sustainability as defined by the European Commission (Art 3 of the EU Sustainability Taxonomy Regulation)

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Substantial contribution to one environmental objectives (e. carbon neutrality, biodiversity etc. - all defined by the Taxonomy Regulation)



Economics

Does not significant harm (DNSH) to other environmental objectives



Law

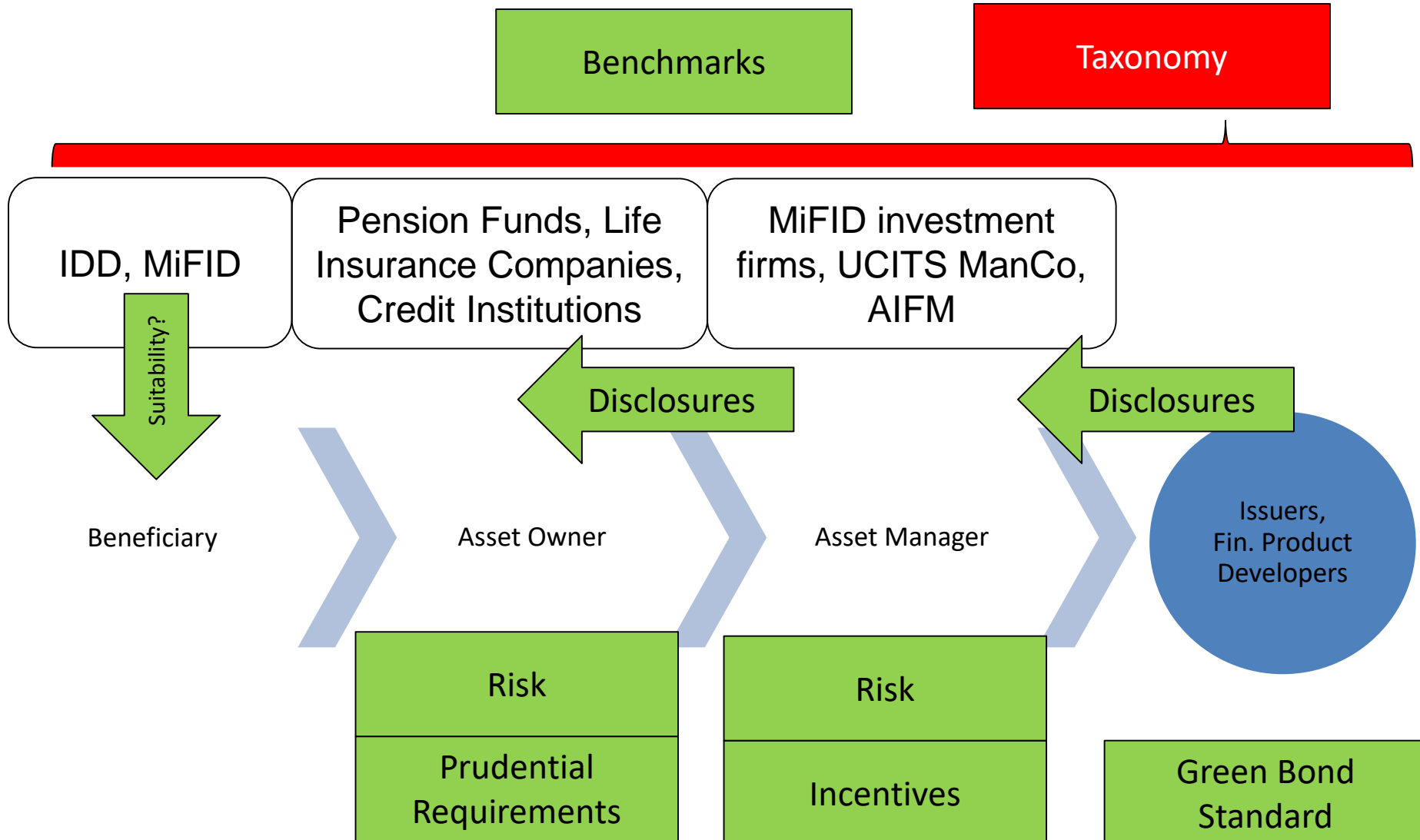
Compliance with Minimum Legal Safeguards (Art. 18 Taxonomy Regulation)

OECD Guidelines for
Multinational Enterprises
(supply chain, liability etc.)

UN Principles for
Business and Human
Rights

UN&ILO Minimum Labour
Laws, work safety, Social
Insurance

Disclosure Requirements across the FS Value Chain



Potential Impact of SFAP

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- Clarifying terminology
- Ensuring comparability
- Rendering sustainable finance the new normal
- Questions marks on organization (to be continued)

⇒ *Nudging* towards sustainability

⇒ Not: mandating sustainability

- Distribution: integrate ESG into « suitability test » on behalf of clients
- Organisation: remuneration?
- Operations: consider ESG risks in daily operations; adjust fiduciary duties (not: always invest sustainable!)
- Risk Management: Consider (very) long-term impact
- « Suitability » for distribution, investments?



Asset Owners,
Asset
Managers,
Distributors



not implemented

II. Green Deal & Renewed SF Strategy: What is to come?

The EU's New Green Deal

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- (even) more capital
- Public-private partnerships
- Additional EU programmes
- From high to super-high on the agenda
- Enhanced speed
- New Sustainable Finance Agenda – consultation March 2020 onwards

- 1. Strengthening the foundations for sustainable investment by creating an enabling framework, with appropriate tools and structures.** “Many financial and non-financial companies still focus excessively on short-term financial performance instead of their longterm development and sustainability-related challenges and opportunities.”
- 2. Increased opportunities to have a positive impact on sustainability for citizens, financial institutions and corporates.** “This second pillar aims at maximising the impact of the frameworks and tools in our arsenal in order to “finance green”.”
- 3. Climate and environmental risks will need to be fully managed and integrated into financial institutions and the financial system as a whole, while ensuring social risks are duly taken into account where relevant.** “Reducing the exposure to climate and environmental risks will further contribute to “greening finance”. Objectives of this consultation and links with other consultation activities.”

- Furthering green funds?
- asking retail investors about preferences?
- consumers' financial literacy
- Measures against short-termism?
- passive index investing
- adapting rules on fiduciary duties, best interests of investors/the prudent person rule, risk management and internal structures and processes in sectorial rules **to directly require them to consider and integrate adverse impacts of investment decisions** on sustainability (negative externalities)

⇒ From nudging to mandatory?

- KPMG report more or less silent on SF
- COM AIFMD II review: considering renewed SF agenda
- **AIFMR Regulatory Reporting template (62.1):**
If more detailed portfolio reporting? more details on sustainability-related information, e.g. risk exposure and/or impacts? E.g. sustainability-related data, in particular on exposure to climate and environmental risks, including physical and transition risks (e.g. shares of assets for which sustainability risks are assessed; types and magnitudes of risks; forward-looking, scenario-based data)

- Full section on ESG/ sustainability (p. 77 et seq.)
 - Question 91. Should **investment decision processes** of any AIFM **integrate the assessment of non-financial materiality**, i.e. potential principal adverse sustainability impacts?
 - Question 92. Should the adverse impacts on sustainability factors be integrated in the **quantification of sustainability risks** (see the example in the introduction)?
 - Question 93. Should AIFMs, when considering investment decisions, be required to take **account of sustainability-related impacts beyond what is currently required by the EU law** (such as environmental pollution and degradation, climate change, social impacts, human rights violations) alongside the interests and preferences of investors?

- Full section on ESG/ sustainability (p. 77 et seq.)
 - Question 94. The EU Taxonomy Regulation 2020/852 provides a framework for identifying economic activities that are in fact sustainable in order to establish a common understanding for market participants and prevent green-washing. To qualify as sustainable, an activity needs to make a substantial contribution to one of six environmental objectives, do no significant harm to any of the other five, and meet certain social minimum standards. **In your view, should the EU Taxonomy play a role when AIFMs are making investment decisions, in particular regarding sustainability factors?**
 - Question 95. Should other sustainability-related requirements or international principles beyond those laid down in Regulation (EU) 2020/852 be considered by AIFMs **when making investment decisions?**

⇒ From nudging to mandatory?

Main takeaways from 10+ ESMA statements

- General concerns about the lack of a “clear and appropriate taxonomy and labels” on ESG terms **at the time investment firms, institutional investors and assets managers are requested to disclose** how they integrate sustainability risks in the investment decision-making process or advisory process
- **importance of proportionality** to allow a smooth sustainability transition to smaller firms
- Adoption of a **principle-based approach.**

⇒ A message of caution

Main takeaways from 10+ ESMA statements

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- Data is key => **single EU data platform covering both financial and ESG information**
- Sound risk management
- Ensure investors and consumers have access to SF products safely and transparently
- Supervisory convergence

IV. Principles for Regulating in the Dark

1. State of Ignorance

- Lack of Experts' Consensus
- Lack of Certain Data Sustainability – Finance
- Lack of Consistent Application

⇒ As of now Zero data on Taxonomy, Benchmark results

⇒ Regulators regulate in the Dark

1a). Lack of Expert Consensus

- No widely acceptable models on key issues (eg « greenium »)
- Huge variety in results

⇒ Further work necessary

1b). DATA

- Right now we do not know how sustainability impacts on profitability

- Frankfurt School UCITS study (2020): 28 out of 101 « green » UCITS did not disclose sufficient data; cash flows of the remainder often currently not uniformly classified by taxonomy

- ⇒ Not even speak about traditional UCITS
- ⇒ Further work necessary
- ⇒ Standing the test of reality

1c). Inconsistent Application

- Complex legislation adopted in 2019 and 2020
- Too much, too fast:
 - (1) integration of new standards in IFRS, GAAP,
 - (2) **reporting entities** expertise, software tools
 - (3) **information intermediaries** (including benchmark providers) expertise, scoring methodology, software tools
 - (4) **Financial intermediaries** expertise for investment decisions, risk management, software tools
 - (5) **supervisors** expertise for supervisory guidelines, develop and implement data-driven supervisory tools, hire qualified and skilled staff for rigid enforcement

2. How to regulate in the Dark?

- 1) Support building expertise
- 2) Further consistent application of existing rules (guidelines, communication, enforcement) rather than issuing new rules
- 3) Retain openness to innovation: Sandboxes, Waivers, Innovation Hubs => Look at FinTech & RegTech sector

⇒ Avoid unwanted effects of premature regulation

- Delaying the transformation
- Risk of failure through „scandal“ => Taxonomy: weapon production as „ESG compliant“ => „explain“ rather than „comply“
- Regulators to apply humility

3. Sustainable Intermediary Set-up

a) Fitness & Properness

(-) Sustainability Officer, since sustainability is the new normal and impacts on all sectors

(+) Firm-wide training concepts

b) Governance

(-) perceived short-termism addressed through SRD II and EU environmental and supply chain legislation in the making; wait for analysis => 5 years

c) Remuneration

(-) Too complex for regulating in the Dark; wait for analysis => 5 years

4. Sustainable Operating Business

- a) Investment and risk policies dépend on data and model progress
- b) Transformation to create model risk => enhance experimentation rather than mandatory rules
- c) Prudential requirements extremely difficult to write and apply
 - ⇒ Avoid detailed CRR style rules across the FS sector
 - ⇒ Code-style / comply or explain approaches / open standards > rules

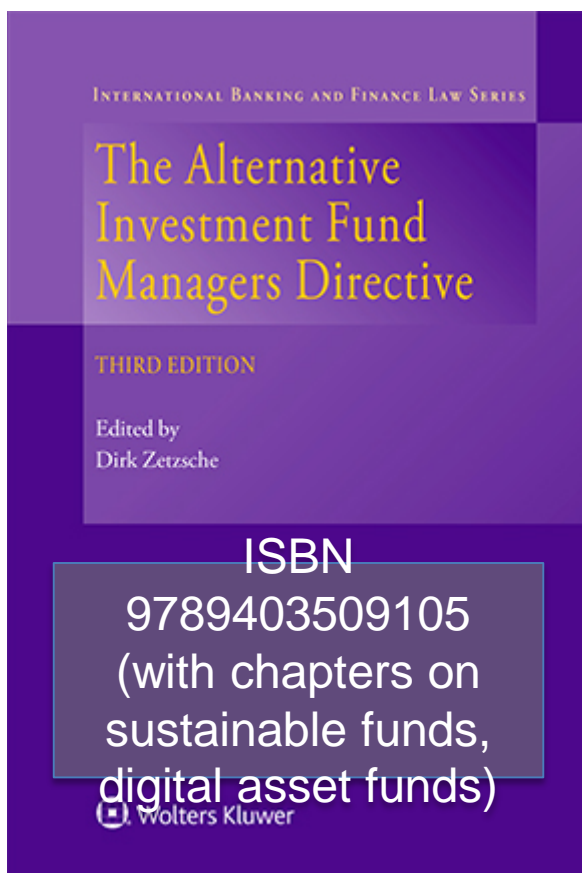
V. Conclusion & Thesis

- Sustainable Finance is of paramount importance.
- Taxonomy and SFAP 2018: comparability, disclosure. Good.
- Nudging approach of SFAP I ambitious, not yet absorbed.
- Current state; lack of data, consensus, inconsistent application
- Apply « wait and see » approach: highly successful in FinTech sector (China example!).

Conclusion – the right regulatory order

- Step 1: Implement taxonomy across sectors
- Step 2: Ensure reporting based on taxonomy ;
- Step 3: Collect data (and ensure data platforms, comparability etc.)
- Step 4: Assess data with some representative time series
- Step 5: draft rules & standards on the organization of intermediaries
- Step 6: review whether shift from nudging to mandatory > costs.

Thank you!



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