Pathways to Sustainable Value Creation through The European Union's Sustainable Finance Framework: Are We Dancing With The Devil?

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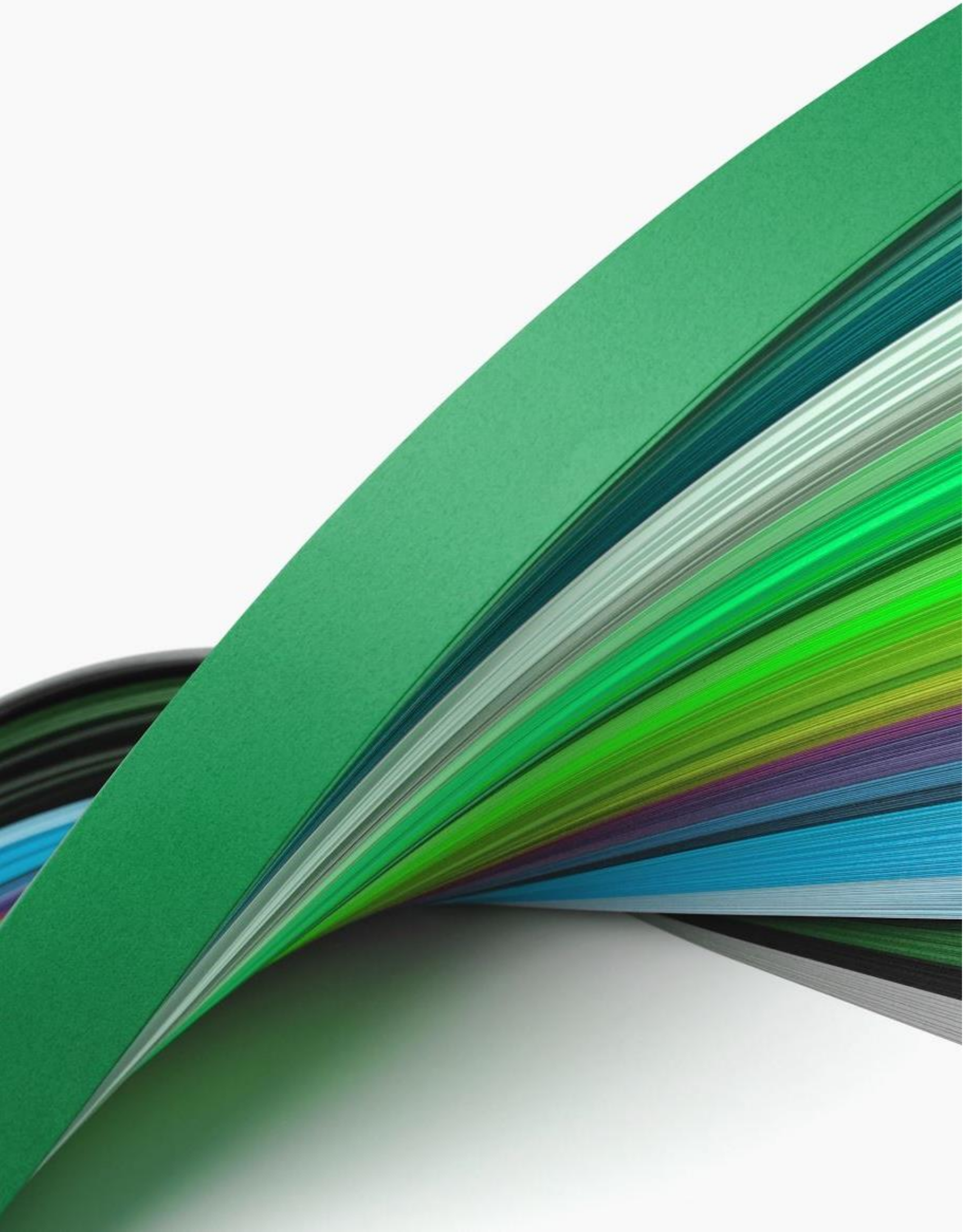


Introducing the argument

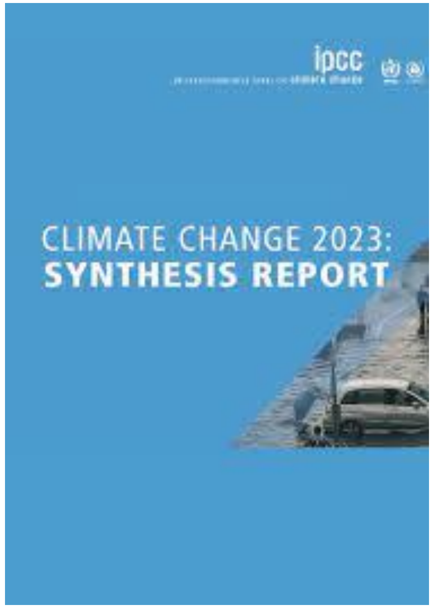
- The EU's Sustainable Finance Action Plan – channeling public and private funds towards support of sustainable activities.
- The sustainable finance action plan could offer progress by seeking to embed sustainability considerations into the financial decision-making processes and by putting sustainability reporting on a par with financial reporting.
- BUT is it merely a "nudge"?
- Will finance actors continue unheeded in their freedom to benefit from their 'regime of accumulation'?
- We require a mechanism to enable stakeholders and communities to participate fully in the shaping and implementation of the regulatory framework.
- Mazzucato - *The Value of Everything*:
- "the definition of value is always as much about politics and about particular views on how society ought to be construed, as it is about narrowly defined economics."

Structure of the paper

- Part 1: description of company law structures, financialization and how financial actors have contributed to climate change and sustainability challenges
- Part 2: overview of the EU Green Deal policies and description of the sustainable finance disclosure legislation
- Part 3: critical analysis highlighting the limitations of the framework
- Part 4: Suggestions for structural changes needed

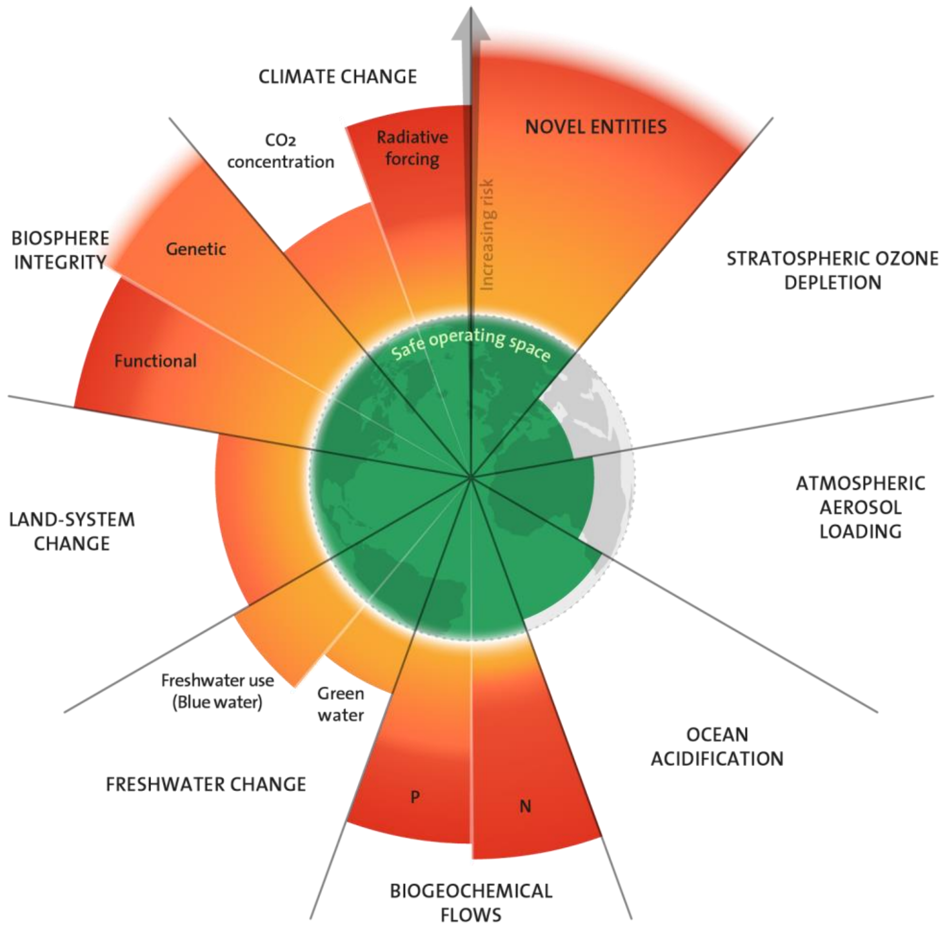
The context

Antonio Guterres, the UN Secretary General, stated at the COP 27 Summit in Sharm-el-Shaikh in Egypt in November 2022, that 'we are in the fight of our lives and we are losing' and that 'we are on a highway to climate hell with our foot still on the accelerator'



IPCC most recent report (2023) expresses the need for urgent action in the starkest terms: 'there is a rapidly closing window of opportunity to secure a livable and sustainable future for all.'

Stockholm Resilience Centre 2023



Earth is now "well outside the safe operating space for humanity"

The causes: corporations are key polluters and key extractors

- Corporations as the ‘principal agents’ of greenhouse gas emissions.
- Familiar examples: 1989 Exxon Valdes Oil Spill, Bhopal’s Gas leak in India in 1984 , BP’s Deepwater Horizon Oil Spill in 2010, the Amazon forest fires and other deforestation

Corporate law and resource extraction

- Cornerstone principles of corporate law universally: separate legal personality and limited liability for shareholders
- Corporate structure typically separates managers and shareholders
- a hierarchy - boardroom decides on business strategy and is accountable to the shareholders in general meetings with the aim ultimately to make profit
- the remaining stakeholders (labour, customers, the environment, communities etc) are treated as contributors to the production processes that give rise to the wealth accumulation enjoyed by the owners and managers.
- Separate legal personality gives to the company an autonomous legal status and a protective barrier from legal responsibility for its members or for other companies within a corporate group, shielded by a ‘veil of incorporation’.
- Corporate groups and global supply chain structures make attribution of liability more difficult

Dominance of shareholder primacy

- A growth of shareholder primacy worldwide

- Shareholder primacy endorsed by international organizations such as OECD, IMF, World Bank etc.

- Directors’ duties whilst owed to the company are typically interpreted as requiring them to act for the benefit of the shareholders – maybe, as in the UK, whilst taking into account the interests of other stakeholders. Shareholders are number one.

- An enduring ‘myth’ of shareholder primacy but this remains central to directors’ decision-making

Financialization

- Profits sought through financial rather than trade and commodity productive channels.
- Financialization has given rise to a ‘simplistic conception of corporate governance as an “agency problem”, a straightforward question of investor protection.’
- 1980s and 1990s a highly liberal order was developed that welcomed finance and money-market innovations (Ireland, 2009)
- As ‘shares became increasingly concentrated in the hands of institutions’ so too the control rights attached to shares …. became a source of considerable power.’ (Ireland, 2009)
- Growth of investor chains – double agency and principals.

The consequences of financialization

- Investor chains - byzantine corporate structural arrangements -
- ‘disconnected capitalism’ different rhythms and cycles of nature and capital
- Separation between global north and global south
- Corporate detachment – main polluters
- Evans: *Right now the small proportion of the world’s population who either hold significant shares in large corporations or sit on their boards are completely divorced from the on-the-ground environmental and human rights consequences of a company’s decisions. The toxic chemicals from a manufacturing plant pouring into a town’s river, or discrimination against migrant workers in the factories of their suppliers, are issues these stakeholders may never witness or experience. They do not feel the human or environmental toll of squeezing margins or producing faster, cheaper, more.*

Financialization’s externalities

Economic growth may lead to higher consumption levels, more energy use and more manufacturing and production - More extraction - Price distortions
Financialization and exploitation of nature
Oil and gas industries often benefit from financialization

Subordinated financialization – uneven environmental impacts and uneven capital accumulation – more for the advanced economies but less for developing peripheral economies

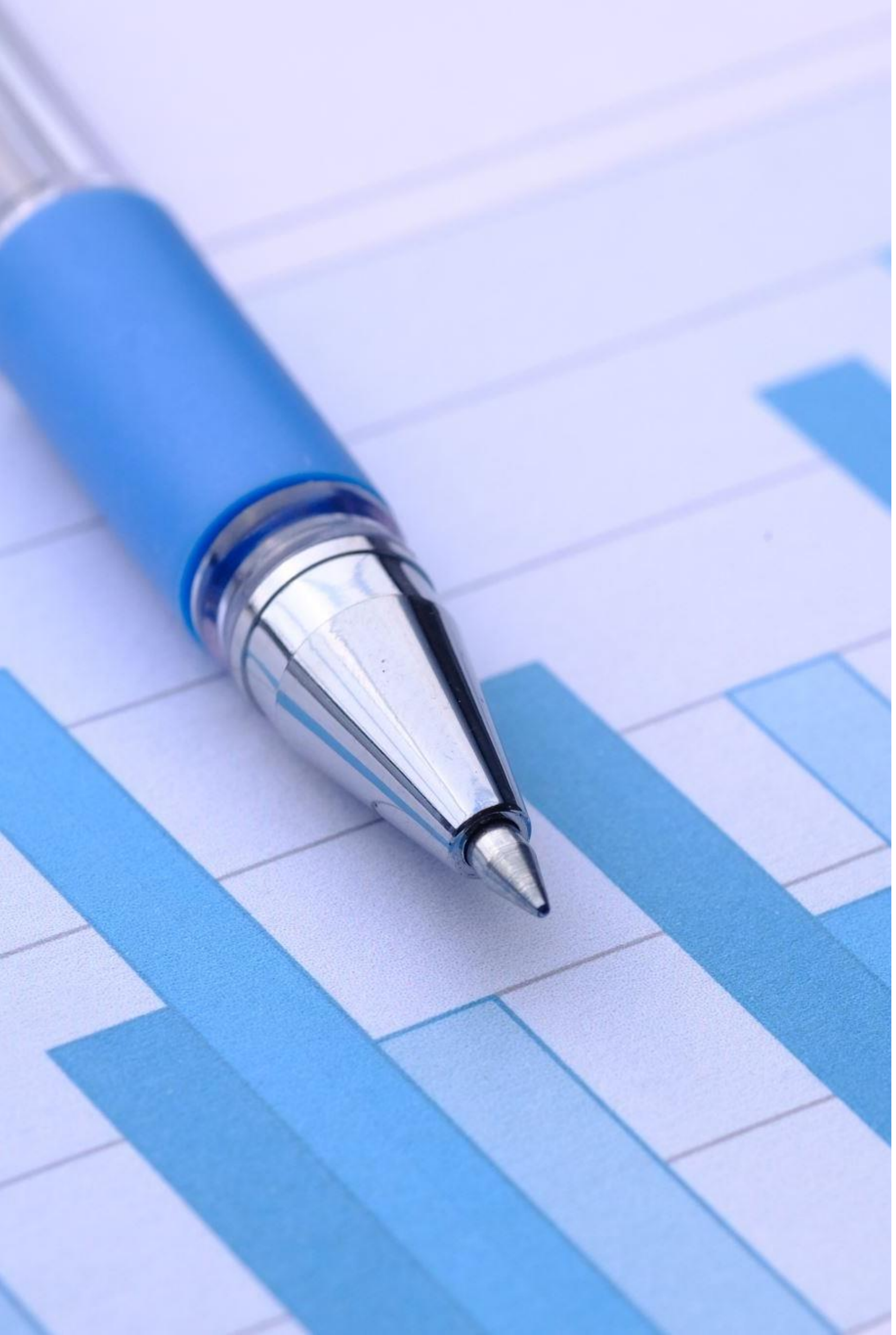
Global inequalities and ecological destruction

Complexities of finance

Greenwashing of “dirty funds” and virtue signalling – Apple and “Mother Nature”

Accumulation is a key motivation

Distorts our understanding of value – ignores production and labour contribution

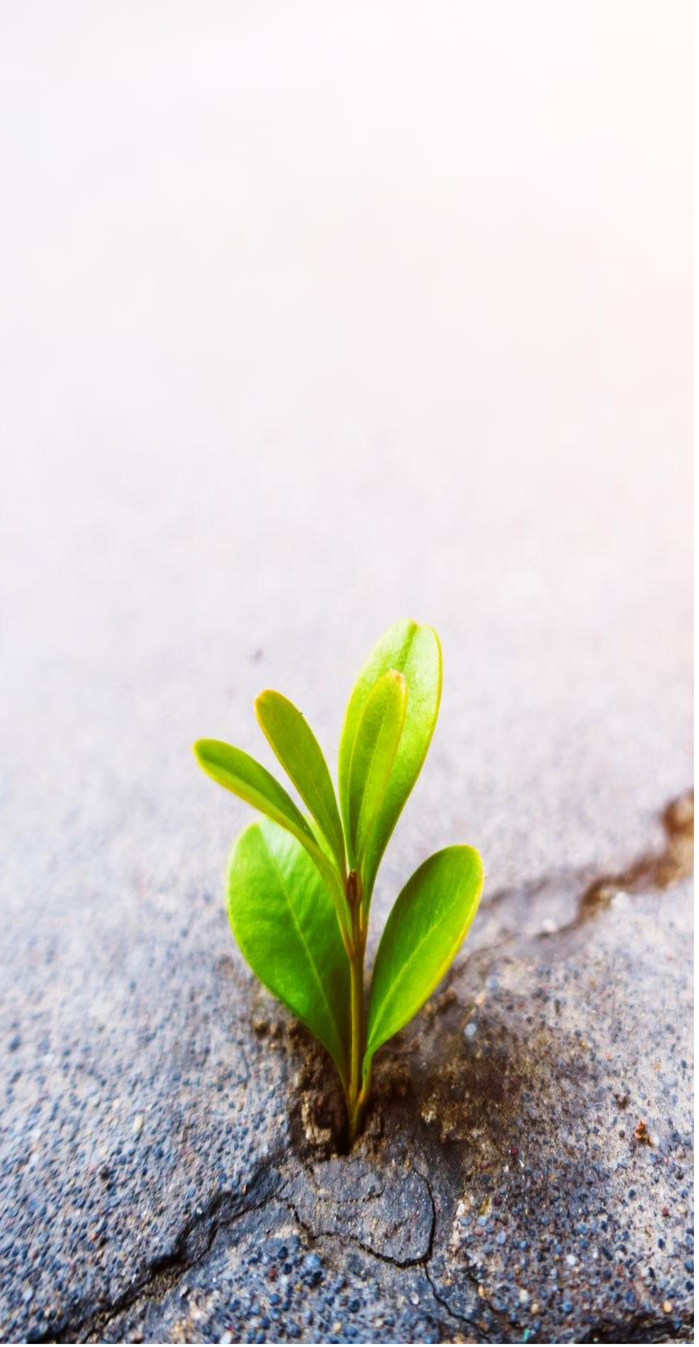


Disclosure laws as a response to corporations and capital influence: from financial to non-financial reporting

- Transparency - the price to be paid for the twin privileges of separate legal personality and limited liability.
- a process for companies to measure their behaviours and impacts and account for them in their annual reports
- underline management accountability
- ‘shareholder primacy’ reflected in much of the reporting framework,
  - financial reporting, or
  - non-financial reporting - highlights the financial risks connected to non-financial impacts

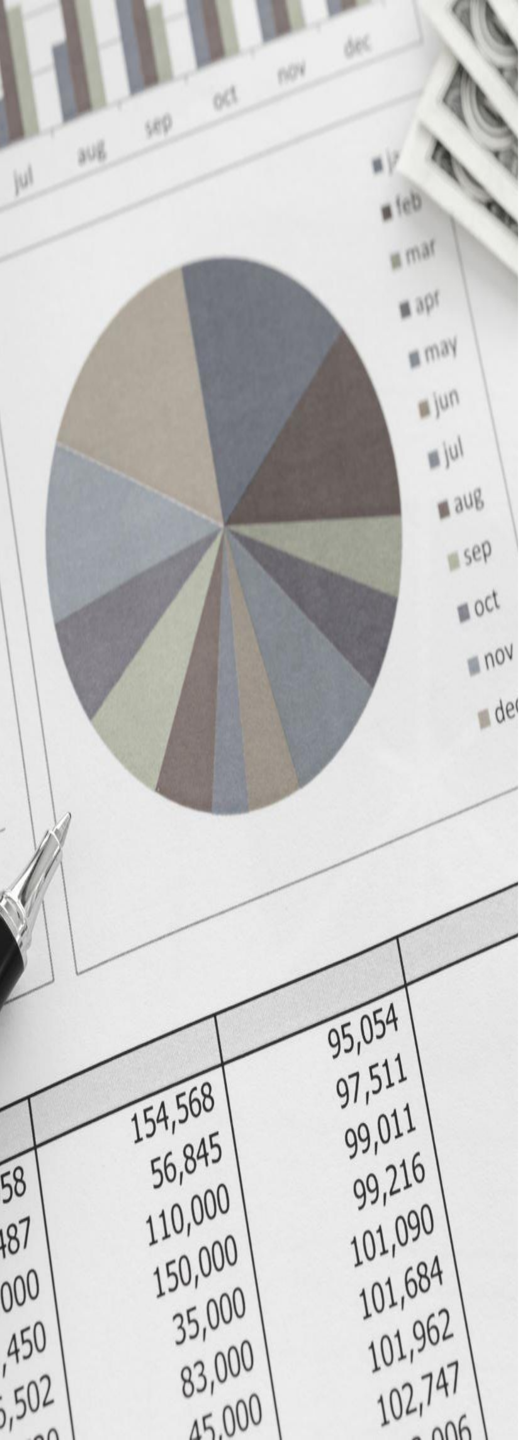
Non-financial reporting

- performance measurement and supplementary reporting - not a reformulation of corporate financial accounting….
- ….. suggesting ways of incorporating the interests of the environment and society in a form that enhances rather than detracts from financial performance.' (Mayer et al, 2021).
- Non-Financial Reporting Directive (NFRD) 2014 requires relevant companies to disclose information about their environmental activity (and other non-financial matters) - does not have to be assured or audited.
- A step forward, focused on non-financial risks - 'disclosure of non-financial information is vital for managing change towards a sustainable global economy by combining long-term profitability with social justice and environmental protection.'
- Problems of lack of verification/assurance, lack of comparability, information overload, greenwashing



The EU's Green Deal and Climate Action Agenda

- Paris Agreement and UN SDGs – the foundation for the EU agenda -an anchor in The European Commission's communication November 2016 on the next steps for a sustainable European future
- December 2019, the Commission presented Its European Green Deal as a growth strategy aiming to make Europe the first climate-neutral continent by 2050
- Communication May 2020 - EU Biodiversity Strategy for 2030: Bringing nature back into our lives , 2050 world's ecosystems to be restored, resilient and adequately protected.
- January 2020, European Green Deal investment plan to mobilise at least €1 trillion of sustainable investments over the next decade.
- Plus an 'enabling framework' – to facilitate and stimulate the public and private investments needed.



A key role for the financial sector

- the financial sector can:
  - re-orient investments towards more sustainable technologies and businesses;
  - finance growth in a sustainable manner over the long-term; and
  - contribute to the creation of a low-carbon, climate resilient and circular economy.

- an action plan on financing sustainable growth in the framework of the Green Deal and the new strategy for financing the transition to a sustainable economy.
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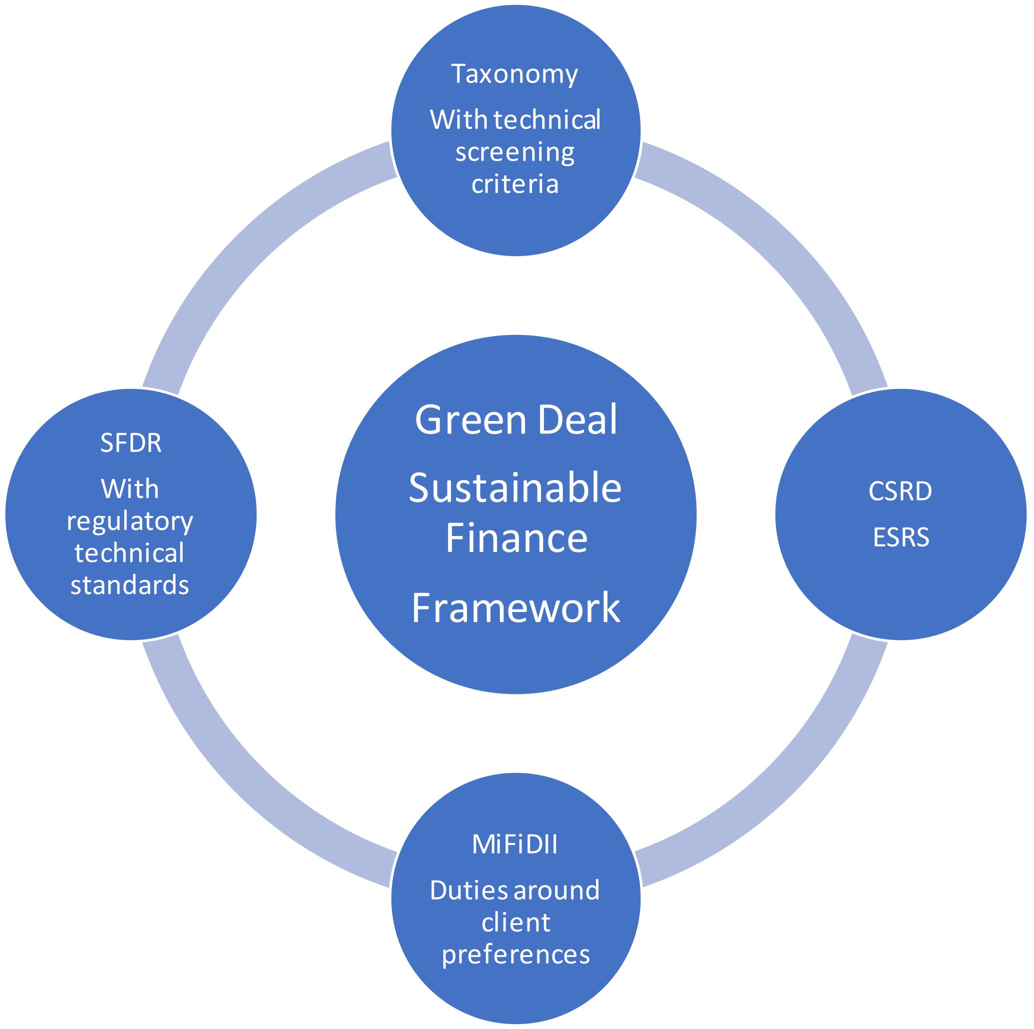
- guidance for the financial sectors on what economic activities can be considered as sustainable and to requirements on the reporting on their activities.

A Sustainable Finance Framework



A green finance reporting framework

- Taxonomy Regulation adopted in 2018 (+ Technical Screening Criteria)
- Sustainable Financial Disclosures Regulation 2019 (+ Regulatory Technical Standards)
- Corporate Sustainability Reporting Directive applicable from January 2023 (+ European Sustainable Reporting Standards).
- MiFiDII new duties of financial actors to consider clients’ sustainability preferences and align with the sustainability framework
- Financial-sector and non-financial sector corporate reporting required to undergo significant changes

The Taxonomy Regulation

- Supports the European Commission’s action plan on financing sustainable growth, the aim being
  - ‘to reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth.’
- The Taxonomy Regulation identifies also:
  - a need for these capital flows to be ‘underpinned by a shared, holistic understanding of the environmental sustainability of activities and investments.’
- two key functions:
  - to provide a common language for talking about sustainability and
  - to offer objective, quantifiable criteria for assessing businesses.
- aims to provide clarity for the financial sector

Operation of the Taxonomy Regulation

- Six environmental objectives :
- (1) Climate change mitigation;
- (2) Climate change adaptation;
- (3) Protection of water and marine resources;
- (4) Transition to a circular economy;
- (5) Pollution control;
- (6) The protection of ecosystems.

- An economic activity qualifies as an environmentally sustainable activity if:
  - it makes a substantive contribution to one of six environmental objectives;
  - it does no significant harm to the other five objectives;
  - it aligns with the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights, including the declaration on Fundamental Principles and Rights at Work of the International Labour Organisation (ILO), the eight fundamental conventions of the ILO and the International Bill of Human Rights; and
  - it complies with technical screening criteria.

Technical Screening Criteria

- Level 2 Technical Screening Criteria provide guidance as to whether or not such activities can be regarded as sustainable, in accordance with the Taxonomy principles of substantially contributing to or doing no harm.
- measures adopted by Member States or by the Union that set out requirements for
    - financial market participants or issuers in respect of financial products or corporate bonds that are made available as environmentally sustainable;
    - financial market participants that make available financial products; and
    - undertakings within the scope of the NFRD which are subject to the obligation to publish a non-financial statement or a consolidated non-financial statement

Delegated Acts

- Commission to adopt delegated acts establishing the technical screening criteria for determining qualification of sustainable activity

- Commission is also required to establish technical screening criteria for determining whether that economic activity causes no significant harm to one or more of those environmental objectives.

- The delegated acts are required to provide detailed criteria, based on scientific evidence, that respect the principle of technological neutrality, build on existing market practices and EU legislation and take into account life cycle impacts.

The Sustainable Finance Disclosure Regulation

lays down sustainability disclosure obligations for financial market actors requiring them to provide detailed information that assists financial advisers and investors to understand the sustainability risks involved in all investment processes and for financial products that pursue the objective of sustainable investment.

Such information will apply at two levels:

entry level - disclosure for the entities themselves concerning their policies on decision-making on sustainability risks; and

product level - information relating to the financial products and their sustainability risks.

Regulatory technical standards specify the exact content, methodology and presentation of the information to be disclosed, with the aim of improving the quality and comparability of information provided.

Corporate Sustainability Reporting Directive

- Aims:
- to obtain better data from companies about the sustainability risks they are exposed to, and their own impact on people and the environment,
- to make companies more accountable and to improve the reliability, comparability and relevance of the information
- to tackle the lack of precision in the current requirements, and the large number of private standards and frameworks in existence
- to ‘bring clarity and certainty on what sustainability information to report and make it easier for preparers to get the information they need for reporting purposes from their own business partners.’

CSRD requirements

- Companies in scope are required to provide in the management report clearly identifiable information covering sustainability matters, including at least:
- the undertaking’s business model and strategy, noting resilience to risks and opportunities;
- plans to ensure the undertaking’s business model is compatible with the transition to a sustainable economy and with limiting global warming to 1.5 °C
- relevant policies and roles of administrative, management and supervisory bodies;
- the principal risks to the undertaking related to sustainability matters, including a description of the undertaking’s principal dependencies on those matters, and how the undertaking manages those risks.
- Where applicable, the information included in the management report shall also include information about the undertaking’s own operations and its value chain, including its products and services, its business relationships and its supply chain.

European Financial Reporting Advisory Group: European Sustainability Reporting Standards

ESRS: to enable companies to report in compliance with the Directive. These standards build on and contribute to international standards and help to ensure the interoperability of the reporting requirements

The ESRS are comprised of two cross-cutting standards and ten topical ESRS. The cross-cutting standards, ESRS 1 (general requirements) and ESRS 2 (general disclosures) apply to all three key sustainability matters (environmental, social, and governance).

The ten topical ESRS organise the disclosure requirements in more detail per sustainability matter.

Matters include environmental issues such as climate change, pollution, water and marine resources, biodiversity and ecosystems and resource use; social issues, including information on the use of the workforce, diversity and inclusion, communities impacted by business operations; and governance issues such as business conduct internally including for example diversity and company boards, and externally including anti-corruption and bribery.

Wider coverage of the CSRD

- The CSRD extends the scope from those covered by the NFRD to include
    - all large companies and
    - all companies listed on regulated markets (except listed micro-enterprises),
- and so increases significantly the number of companies required to report to approximately 50,000.
- The CSRD, unlike the NFRD, requires reported information to be audited and companies to digitally ‘tag’ the reported information, to make it machine readable, feeding into the European single access point envisaged in the capital markets union action plan.

A critique (1)

- **Strengths**
- Taxonomy as a breakthrough – offers more precise criteria for determining what may be sustainable activities
- May help to prevent or reduce greenwashing or sustainability washing
- CSRD double materiality - inward and outward impacts count – a difficult concept but at least does require consideration of external impacts risks
- CSRD information requires verification
- A “smart” mix of regulation? Mandatory/soft/guidelines/standards – nudge rather than comply and control?
-

A critique (2)

- **Scientific base –** the Taxonomy and the technical screening connect to scientific issues. For example, definition of adaptation corresponds to that of the IPCC
- An economic activity shall be considered to contribute substantially to climate change adaptation where:
  - that economic activity includes adaptation solutions that either substantially reduce the risk of adverse impact or substantially reduces the adverse impact of the current and expected future climate on that economic activity itself without increasing the risk of an adverse impact on other people, nature and assets
- However, Controversy over the Complementary Delegated Act, allowing gas and nuclear fuel to be seen as transitionally sustainable.

A critique (3)

Weaknesses

Complexity - Multiple levels of disclosure in accordance with the new ESRS ((sector-agnostic, sector-specific and entity-specific)

Taxonomy – 2500 data points, ESRS: 1800 data points

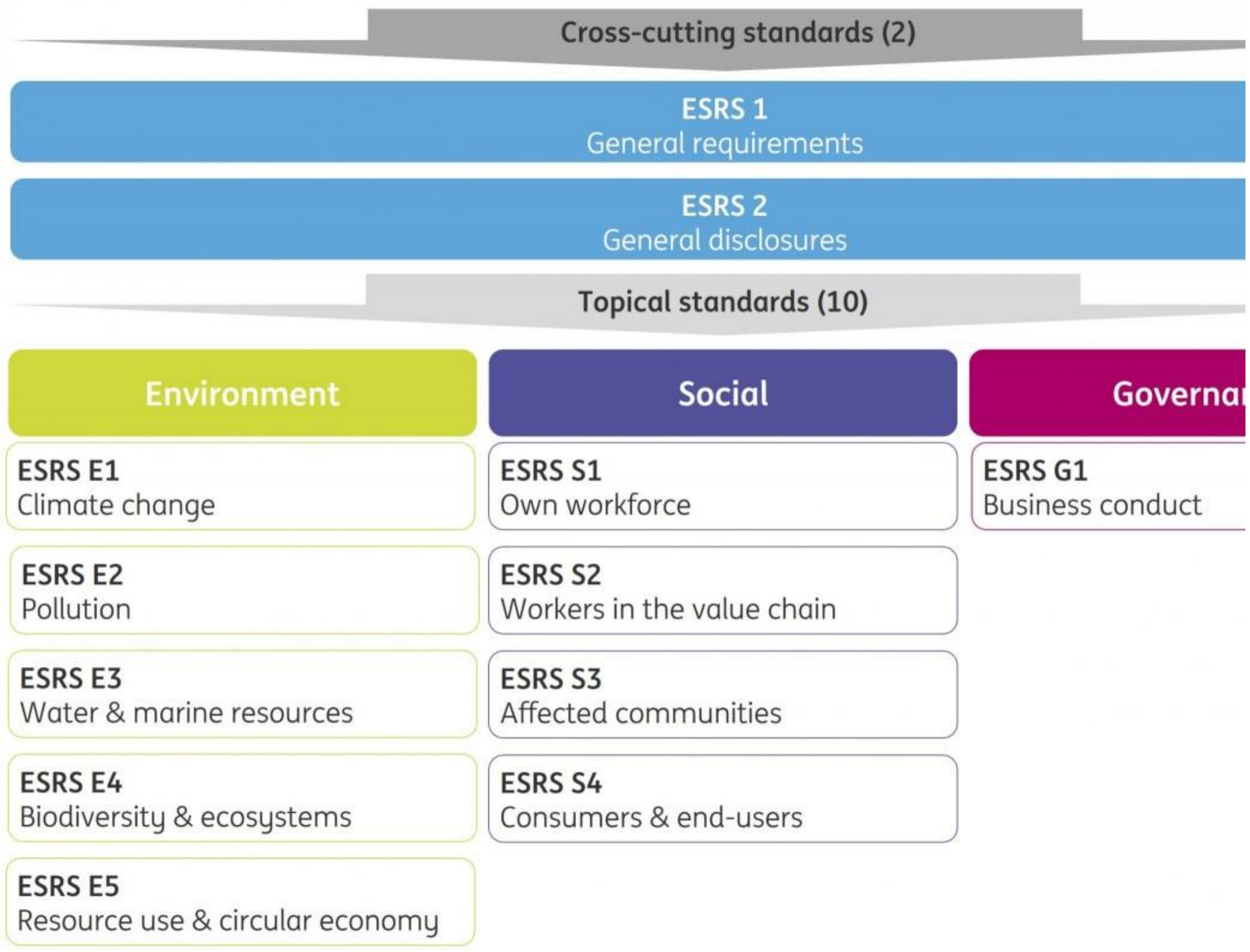
(See next 2 slides)

Need to develop greater understanding of the double materiality concept now in operation under the CSRD: Will require new kinds of expertise and competence in boardrooms to understand climate change and biodiversity impacts and risks

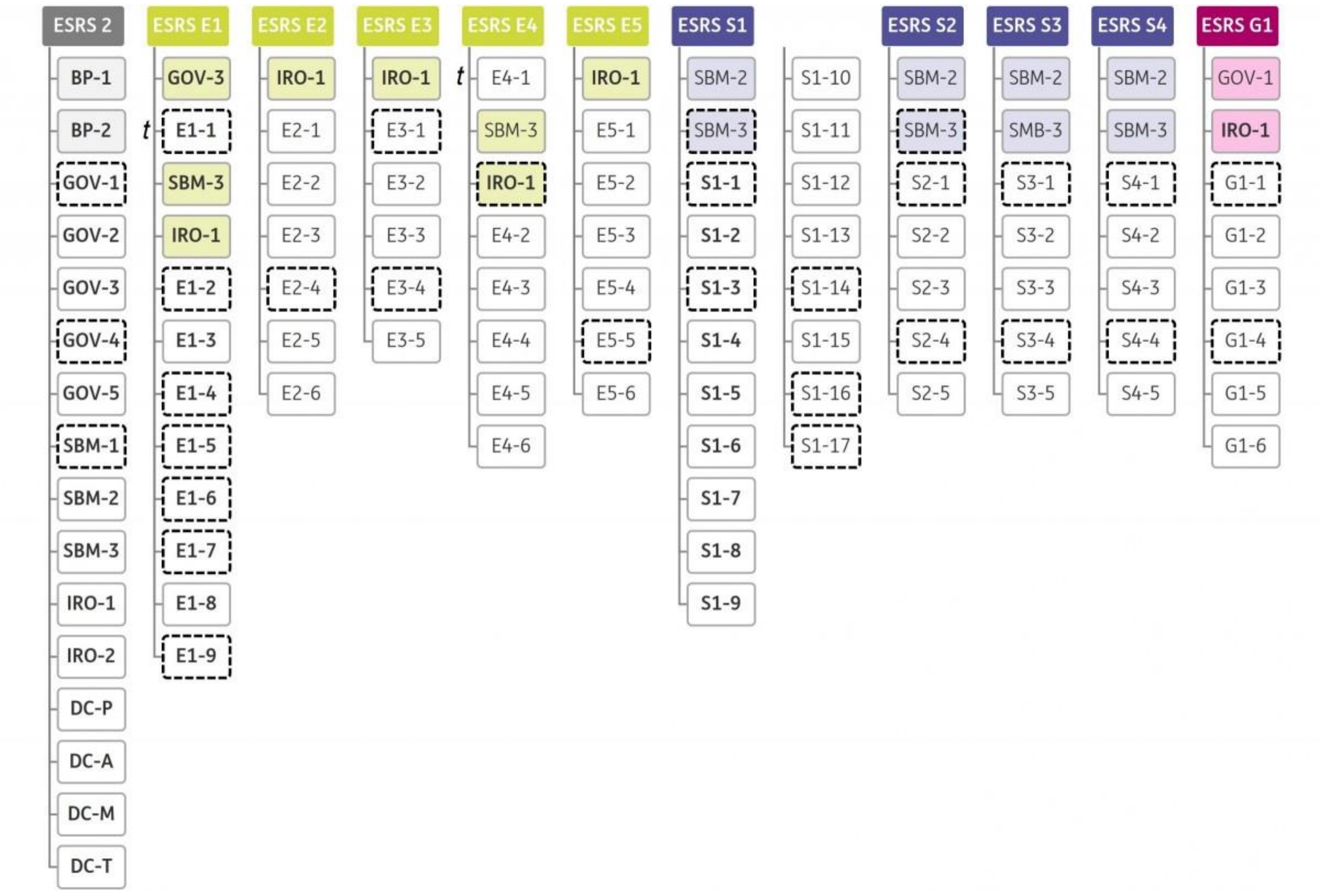
CSRD – as a Directive this leaves room for differences among the member states

Extraterritorial impacts: Not necessarily a negative but could be a cause for disputes if companies not prepared or not in compliance

Different taxonomies: eg UK, China, South Africa, India, Mongolia, Egypt, Bangladesh– to what extent are they aligned? ESRS seek interoperability with GRI and ISSB



ESRS standards



ESRS2 and Topical ESRS: 84 requirements 1144 data points (source: ing)

A critique (4)

- A market-making neoliberal approach - dominance of finance actors in the development of the framework – Technical Experts and Platform for Sustainable Finance – are scientists at risk of being coopted?
- does not challenge the power of financial market actors nor the 'regime of accumulation'
- Still a financialization – can the financial market actors leave behind their quest for shareholder primacy and profit? The Green Deal made clear the EU's preference for an enabling system – enabling for the investors
- Some commentators are optimistic - Eccles and Klimenko - a positive role for ESG investors: too big to let the planet fail, investors demanding these portfolios, millennials aware of climate change, collaboration among investment firms.
- However - Migliorelli "exceptional growth" of labelled sustainable finance but does not necessarily mean that the investments flow towards "sustainable" sectors or activities have increased at the same pace.
- Still a lot of flexibility about what and how to report – still choice about where to invest funds - may lead to imbalance and unequal access to funds

Some questions left unanswered

- Can green capitalism escape the capitalist logic of accumulation?
- Is there an over-reliance on technology – leading to denialism?
- Risk and returns - who really bears the risks? Double materiality is important because it looks at risks and impacts on two levels (impact inside an out of the business) and risk to and from the business and the financial firms – but does this sufficiently protect all the risk bearers?
- Does transparency improve behaviours or just improve information?
- How can we reduce the complexity to achieve transparency?
- Could corporate governance structures have a role to play? Membership of board committees.
- Role of regulators – are they sufficiently educated for sustainability demands?

Some solutions – a question of WHAT and HOW we value ? These are also political questions.

We cannot deny the dilemma faced – a costly transition towards a climate neutral economy is expensive. Are we dancing with the devil by focusing so strongly on the financial actors?

Should we be debating more strongly growth v degrowth? Should we interrogate more fully what we mean by wealth and abundance? And for whom? Should we identify those products that are without value or have a negative value and prohibit their manufacture and sale?

Still a need to challenge the shareholder primacy that pervades this space - ownership design and different approach to management through servant leadership might change priorities and corporate purpose.

Need a more democratic approach that involves affected communities, youth and scientists and not just the market "experts" – they can guide on impacts as they experience or understand those impacts

Should we impose enforceable duties on the financial market actors? If so what duties, to whom and how to be enforced?

States and regulators should not be pushed aside and may have to go beyond a nudging approach

Conclusions

- There is a role for private market actors but holding onto the market logic risks perpetuating the problems and worsening them as capitalism both internalizes and capitalizes further on the problems identified with corporate and financial action
- A further risk of rebound and replacement (and further environmental harm) as we rely more on new technologies.
- Calling on market actors should not push states and communities out of the frame.
- Rather than nudge them towards sustainability we may have to command the financial actors to do what is needed.
- Regulators need further education on sustainability science and the connections with law and regulation.
- We need to think about what we mean by wealth and abundance – for all or for a few? This connects also to the growing tension between growth and degrowth – a developing debate.