CHAPTER 11

ESG Targets for the Financial Sector and the Choice of Legal Instruments

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11.1 Introduction

Environmental, Social and Governance (ESG) is a topic of high priority within financial supervisory law. The climate change and challenges of our time create an urgency for effective and efficient legislation and regulation. More than 12 years ago, during the financial crisis, there was also great urgency for stabilising and confidence-building supervisory legislation. History shows that crises give rise to reforms in financial regulation and supervisory law (Gerding, 2013). ESG legislation is taking shape during a similarly urgent period (Busch et al., 2021; Camara, 2022; Hill, 2020). This chapter deals with the question of which legal and regulatory instruments are appropriate to incorporate ESG targets into the business of financial institutions and the related internal and external supervision. As ESG can be seen as an important key concept in the discussion on a sustainable, future-oriented financial sector, the question needs to be

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answered whether the path of soft law or hard law can be chosen, or a combination of both.

Governance, business strategy, risk profile, product development and remuneration policy are aspects that are part of the internal sphere of companies. In the financial sector, these aspects are increasingly regulated by hard law, often after a transformation from soft law and corporate governance principles. The European legislative framework on sustainability and Green Finance is materialising increasingly, notably through the Taxonomy Regulation and Sustainable Finance Disclosure Regulation (European Commission, 2019, 2020). European laws and regulations are not exhaustive, there is room for ambitions and goals that are formulated in the sphere of soft law, self-regulation and corporate governance. This chapter offers an analysis and interpretation of a multi-level approach to ESG targets for the financial sector.

11.1.1 Research Question

Rules on transparency and taxonomy have taken shape in hard law, in conjunction with a range of related formal requirements (European Securities and Markets Authority, 2022). Material standards, and the actual achievement of ESG goals, are more difficult to translate into hard legislation, partly due to their empirical nature. An (international) increase in best practices, industry codes, principle-based regulation, and other forms of legally non-binding agreements is evident (Katelouzou & Klettner, 2022). Several international organizations, financial institutions and non-governmental organisations are involved in the creation of these forms of soft law (Katelouzou & Zumbansen, 2021; Van Rijsbergen, 2021). From this development, a multilevel regulatory system of ESG and Green Finance is emerging. This development is encouraging but also has fragilities. Especially with regard to the question how the various hard and soft law rules relate to each other. Hard law rules are secured through supervision, enforcement and potentially sanctions. Traditionally, soft law is seen as more non-committal in nature, due to the lack of hard compliance obligations (Lancri, 2019). An understanding and interpretation of the functioning of the layered system of ESG regulation, now and in the future, necessitates the following research question:

Which regulation, governance and standard setting on ESG objectives for financial institutions lend themselves to self-regulation and soft law, complementary to the hard law framework?

Approach and structure. The approach to answering this question will be to provide an overview and background of international financial regulation and, against this backdrop, to map the current affairs in ESG hard law regulation, particularly at the European level. Furthermore, an overview of corporate governance theories will be provided and of soft law and self-regulation as it pertains to sustainability and green finance. This chapter aims to contribute to the discourse concerning the suitable place for soft law and self-regulation, in an overall system aimed at maximising ESG objectives. Inspiration will be drawn from the lessons of the 2008–2012 financial crisis and the relationship between hard law and soft law that emerged during and after the crisis.

This chapter is structured as follows. Section 11.2 contains a compact overview of the development of (international) financial regulation. Section 11.3 follows an account of the European approach to ESG, focusing on key legislation and bodies involved. Section 11.4 analyses the role and place of soft law and self-regulation in relation to ESG, followed by Sect. 11.5 in which Green Corporate Governance is discussed as an evolved form of good business and financial governance, to complement already existing theories of corporate governance. Section 11.6 aims to bring together the preceding sections with a focus on multilevel ESG regulation after which Sect. 11.7 draws a conclusion.

11.2 The System and History of International Financial Regulation

11.2.1 Introduction

To understand the current and future place of ESG regulation within the existing international financial legal system, it is useful to provide a brief sketch of the international financial regulatory landscape (Nelemans, 2018). Financial regulation has traditionally focused on promoting the stability and continuity of financial sectors. In the almost 100 years that financial sectors have been controlled through supervision and regulation, it has evolved into an extremely large and complex system that pursues multiple goals. Modern financial regulation aims to regulate, among other

things, stability, integrity, market access, consumer protection, supervision and enforcement.

11.2.2 The Period of 1929–1933

The main catalyst for the development and gradual expansion of international financial law is the impact of crises. The origins of the current international system of financial regulation can be traced to the crash of 24 October 1929 and the subsequent Great Depression (Gunderson, 2004). In a three-year period, stock market-listed companies lost 90% of their value. Between 1930 and 1933, 9000 banks failed, savers could no longer withdraw their money and the unemployment rate rose to an unprecedented 25% (Brummer, 2015; Field, 2013). The golden age for US investment banking was the previous period, which last from 1896 to 1929 (Heyzer, 2009). There was no legal requirement to separate commercial banking from investment banking. This created a situation where savings on the commercial side of the bank were used to finance transactions on the investment side of the same bank. The practices contributed to a speculative bubble in the US stock markets (Heyzer, 2009). The decade-long crisis negatively affected all Western countries. In particular, European markets depended on an inflow of capital from the United States and were hit exceptionally hard.

The US government's response during the Great Depression, when many banks failed, was aimed at preventing another crisis. The response was swift and sweeping; in 1933, the Emergency Banking Act and the Glass-Steagall Act were introduced. Under these laws, universal banks were no longer allowed to combine risky investments with standard banking businesses such as savings and loans. Banks had to make a choice and were no longer allowed to operate in both areas, either investment banking or commercial banking (Evans, 2016). Banks were no longer allowed to deal in securities and accept savings at the same time. This policy would be maintained for the next 30 years, until the early 1960s (Willmott, 2017).

European countries did not introduce legislation similar to the US after the Great Crash of 1929, although there was the introduction of banking legislation and central banking supervision aimed at restoring public confidence in the financial sector (Benston, 1990). The crisis had exposed the dangers of mixed banking: the combination of traditional

banking and industrial investments (Westerhuis, 2016). In several European countries (Sweden, Switzerland, Belgium and Italy), banks were forced to separate short-term loans from industrial investments (Pohl, 1995a). Belgium went further than other countries and was the first country to prohibit deposit banks from holding industrial shares, because of volatility and risks (Pohl, 1995b). In Belgium, during the mid-1930s, only deposit banks were allowed to use the term 'bank'. Banks in Belgium were also required to hold a minimum share capital and to publish financial data using standards set by the government. Another notable change in the European banking system during the 1930s was the transformation of Banca d'Italia into a public credit bureau with the mandate to control and monitor Italian banks and to prevent the emergence of an over-concentrated financial sector (White, 1997). The legislation introduced in Europe after the Great Depression was mainly aimed at protecting savings, this had the effect of increasing savings banks (Morrison, 2015).

11.2.3 The Period of 1934–1973

During the next four decades, international financial markets were largely influenced by the effects of World War II and post-war government interventions. Government interventions after the war were aimed at bringing back economic prosperity. The International Monetary Fund (IMF) was officially established in July 1944 when the agreement underlying it was signed at the Bretton Woods conference. The IMF's tasks are to support and promote international financial cooperation, ensure financial stability and promote economic growth (Zamora, 1999). The Bretton Woods conference was held in July 1944 with the aim of regulating the global financial and monetary system, after World War II, despite the fact that the war had not yet ended. The World Bank was also established during the Bretton Woods conference. One of the tasks of the World Bank was to identify valuable investments in developing countries and to provide financing. With the creation of the IMF and the World Bank in 1944, a clear legal and institutional basis for the international monetary system emerged; the Bretton Woods system was created during this period (Butler, 2016).

The rigidity of the Bretton Woods system with fixed exchange rates led to its downfall in the 1960s and 1970s (Moffit, 1984). In the 1960s, the central banks of industrialised countries, the IMF and the Bank of International Settlements would try to coordinate bailouts and prevent

large-scale speculation. Apart from rigid exchange rates, the second drawback of the Bretton Woods system was seen as the over-reliance on the US dollar as the leading reserve currency (Rushefsky, 2013). The United States behaved as the global central bank after Bretton Woods, but the system was not set up for the increased growth in the following decades; this development had not been taken into account in the agreement. The system was based on confidence that the United States could exchange debt securities for gold. However, gold reserves had shrunk due to the international activities of the United States. The gold standard was finally abandoned in the period 1971–1973 (Woods, 2007). After this period, a system of more flexible exchange rates was introduced. The role and function of the IMF and the World Bank changed in the late 1970s (Helleiner, 2015). From that period on, European states focused more on their regional monetary project and were focused on achieving unification. The OECD-EU system also operated separately from the IMF which contributed to its diminished role in the international financial architecture. The creation of the G10, G7 and OECD all contributed to the changed international financial landscape (Buckley, 2016; Schwarcz, 2009).

11.2.4 1970s to Current Times

Over the last decades, the financial sector has changed dramatically and, increasingly, the old architecture of financial regulation is no longer sufficient. From the 1960s onwards regulators would again allow commercial banks to engage in securities trading. The Great Financial Crisis that started in 2007–2008 exposed the problem of systemic risk and 'too big to fail' in a profound and destructive way. The complexity of financial markets and large international financial companies made it impossible to identify structural vulnerabilities in the global financial system in time.

Deregulation and flexibilisation of regulation led to the formation of large international financial conglomerates. These large financial corporations—universal banks and large insurers—are so intertwined with other financial institutions that they cannot be allowed to fail. The complexity and interconnectedness of financial institutions is not easy to reduce, for this reason, in 2022—almost 15 years after the crisis—too big to fail is a (seemingly) politically condoned phenomenon. The structure and architecture of the financial sector have not changed substantially compared

to the pre-crisis period. Requirements for capital, liquidity and leverage ratios have become stricter, mainly because of the third Basel Accord. Comprehensive legislation has also been introduced on both sides of the ocean, aimed at increasing the stability of the financial sector, protecting consumers and investors and increasing confidence in financial companies and the sector as a whole.

The 2008–2012 financial crisis put financial stability and continuity from a micro- and macro-prudential perspective at the centre of financial supervisory law (Barwell, 2017). The Banking Union, the establishment of specialised sectoral supervisors and standard-setters and the bail-in mechanism were introduced to avert another financial crisis. The ECB's financial and monetary policy in the post-crisis years has also mainly focused on post-crisis recovery and averting a repeat. The Corona pandemic can be seen as a real-life stress test of the financial sectors, a test that the banking sector seems to have passed relatively well, given the absence of bankruptcies and large-scale insolvencies of financial institutions.

11.3 The European Regulation of ESG

11.3.1 Introduction

Financial regulation has changed significantly over the past decade. The creation of the Single Rulebook, the European Banking Union and the European System of Financial Supervision, with ESMA, EBA and EIOPA (European Commission, 2010a; European Commission, 2010b; European Commission, 2010c) serve as prime examples of the increase and expansion of European financial supervision. This development can directly be traced back to the financial crisis of 2008–2012. Initially, the European Union did not envision a Banking Union or a unified European financial market. Financial services were traditionally regulated by Member States, with the exception of the regulation of stocks and securities which are traded on international markets. Before the financial crisis, the main legal instrument of financial regulation was the EU directive, which is implemented in national legal systems. One of the critical findings during and after the crisis was that there was too great divergence in the implementation of directives in the member states, for this reason, the European legislator is increasingly opting for legislation through EU

regulations (Nelemans, 2018). Besides stability and prudential supervision, sustainability, future-proofing and effectively implementing green finance can be seen as the next big challenge for the European legislator, supervisor as well as the financial sectors themselves.

11.3.2 The Taxonomy Regulation and Sustainable Finance Disclosure Regulation

At the heart of European ESG regulation are the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation. In doing so, the European Legislator clearly wanted to create a level legal playing field in the EU. With regard to supervision, enforcement and sanctions, this is defensible, as the choice of directives would have meant creating diversity within the member states. This implementation diversity is undesirable if material and formal standards are set from a European level with an accompanying supervision and enforcement system (Garcia Rolo, 2022). The choice of EU regulations as preferred legal instrument also underlines the great importance, from a political, legal and social point of view, given to sustainable, green and socially responsible financial and listed companies.

On the grounds of the Taxonomy Regulation, an economic activity will be deemed 'environmentally sustainable' when it makes a substantial contribution to a predefined environmental objective and it doesn't harm any individual environmental objective, while complying with minimum safeguards as well as specified performance thresholds aka technical screening criteria. Goals under the Taxonomy Regulation include the identification of ecological and sustainable economic activities involving six environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, waste prevention and recycling, pollution prevention and control and protection of healthy ecosystems (European Commission, 2020).

Transparency is required at the entity level on how the company deals with sustainability risks. A sustainability risk is an environmental, social or governance event or circumstance that, if it materialises, has a negative impact on the value of the investment. Examples of environmental risks include physical risks such as extreme weather conditions that reduce the value of the underlying investment, or a transition risk such as the introduction of a carbon tax that could affect an investment

in a carbon-intensive sector (European Commission, 2019). In addition to the two regulations, a European Non-Financial Reporting Directive (European Commission, 2014) has also been issued and a proposal for a Corporate Sustainability Reporting Directive has been published (European Commission, 2021). This European legislation forms the block of 'hard law' aimed at the future-oriented regulation of the financial sectors and pursuing, among others, the goals laid down in the European Green Deal. There is also an extensive body of soft law in the form of ESMA, EBA, EIOPA standards and policies, UN Sustainable Development Goals, Basel Committee on Banking Supervision, Principles for the effective management and supervision of climate-related financial risks, OECD, ESG Investing and Climate Transition.

11.3.3 Balancing ESG Compliance with Other Legal Obligations

Banks and financial institutions are required to comply with a broad spectrum of, increasingly, European laws and regulations. The main regulations relate to market access and licensing, liquidity and capital requirements and governance, compliance and product supervision. This includes tough legislation on market manipulation, competition, privacy and anti-money laundering. How do the pre-existing legal obligations relate to ESG legislation and how should financial institutions act when transparency and taxonomy obligations might clash with rules from competition law and with regard to market abuse?

Another question concerns the case in which a company is in trouble. Is it, under specific circumstances, permissible to adhere to less stringent ESG standards with the aim of prioritising the continuity of the company? If the European banking sector is taken as an example, it can be argued that the Banking Union and related laws and regulations are aimed at managing systemic risks and shocks, promoting sound liquidity and capital standards, and preventing government support for failing banks through a bail-in mechanism paid for by the banking sector itself (Boogaard, 2021; Maddaloni & Scardozzi, 2022). The extensive European financial supervisory legal system was created mainly in response to crises, especially the major Financial Crises of 2008–2012. A similar development has taken place with regard to corporate governance. Because of accounting scandals at the turn of the century, notably Enron, Parmalat and Word Online, corporate governance codes have gained significance

and authority, with the aim of promoting better control, internal supervision, reliable reporting and long-term value strategy (Dobson, 2006; Kokkinis, 2015). In this respect, financial supervisory law and corporate governance are both reactionary in nature. ESG law can also be seen as reactionary, namely due to climate change and major economic, financial and societal challenges of the twenty-first century. Responding to these challenges is not only a matter and responsibility of national and European governments but also of private parties and public–private partnerships (Vecchi et al., 2022).

Within the EU, the regulations ensure a level playing field and the directives will also achieve a large degree of harmonisation, albeit in a form implemented in the national legislation of the member states. The question that can be asked is what impact European sustainability legislation will have on competitiveness vis-à-vis non-EU markets and companies. Regulatory arbitrage, where companies deliberately settle in a jurisdiction with more lenient rules, is a factor to be taken into account when discussing hard European legislation that is lacking or less stringent in other parts of the world. Responding to sustainability, future-proofing and climate change are challenges that are not limited to the borders of the European Union. For this reason, it is important to evaluate the results, positive or negative, of European legislation, including the effects on the competitive position of European companies vis-à-vis non-European market participants.

11.4 What Role Remains for Soft Law and Self-Regulation?

11.4.1 Introduction

The core of sustainable legislation in the EU is enshrined in hard law legislative instruments. In line with traditional financial regulation, the issuing of additional technical standards and further formal and substantive regulation will set further material norms for companies that fall within the scope of the sustainability legislation. Nevertheless, the question of the place and meaning of soft law regulations and initiatives in relation to ESG objectives for the financial sector remains relevant. The arguments for preserving ESG soft law largely converge with the arguments for preserving corporate governance and self-regulation in the

financial sector, in addition to formal financial supervisory law (Krug, 2015; Pacces, 2012).

11.4.2 Hard Law vis-à-vis Soft Law

Before zooming in on the positioning of soft law and self-regulation in relation to ESG goals, it is desirable to outline the advantages and disadvantages of soft law in relation to hard law (Nordhausen, 2008; Soppe, 2016).
Advantages of hard law:

- Legal certainty
- Legal protection through access to the courts
- Predictability
- In principle democratically legitimised.

Drawbacks of hard law

- In rules-based legislation, the rules may become outdated
- In principle-based legislation, further standardisation must take place
- It is less possible to respond promptly and adequately to developments that require attention
- Compliance can possibly result in 'box-ticking'
- Less input from the sector, usually a tight formal framework.

Advantages of soft law

- Flexibility, due to quick adoption and easier adaptation.
- Easier to fit into political, economic and legal systems
- Low transaction costs in the negotiation phase (as compared to hard law)
- Preservation of the sovereignty of Member States.

Drawbacks of soft law

- Non-binding status in principle

- Lesser legal protection (but see Court of Justice of the European Union—Judgement of the Court (Grand Chamber) of 15 July 2021 (ECLI:EU:C:2021:599)
- Democratic status and legitimacy of the drafting body may not be optimal
- Liability for breach of standards is not straightforward
- Supervision of compliance with soft law poses greater challenges compared to hard law.

Regulation of ESG objectives from a purely hard law perspective limits financial markets, industry associations and market participants in the ability to formulate and introduce rules and best practices from within that are appropriate and proven effective. Active and meaningful participation, based on a shared commitment to sustainability goals, has a good chance of increasing compliance and the pursuit of successful integration into corporate cultures and commercial strategies (Ferrarini, 2021). The basis of taxonomy, transparency and reporting is laid down in hard law, equipped with an oversight apparatus in which non-compliance is threatened with future sanctions. The ESG regulatory system however does not require complete governmental regulation and standard-setting. The empirical data concerning impact (positive and negative), market developments and innovation, best practices within and outside Europe and the impact of ESG compliance on the competitive position of European companies should (at least partly) come from the financial sectors (Pagano et al., 2018).

11.4.3 ESG Objectives Through Soft Law Arrangements

Soft law remains in a relevant place within sustainability regulation and the pursuit and safeguarding of ESG targets. Technical standards and policies are being issued by ESMA, EBA and EIOPA that give substance to the broadly formulated provisions in hard law (Batliner & Konzett, 2016; Gortsos, 2020). From the perspective of legal certainty, it is defensible that the European financial supervisors issue these standards and policy documents, as this makes it clearer to supervised institutions what is required of them in terms of compliance. The United Nations is a great catalyst and inspiration in terms of global priority for climate, sustainability and ESG goals. The UN Sustainability Goals have no force of formal law but are nevertheless leading in terms of content and the

recommendations and goals of the UN can be converted into hard law, so that through this transformation process they can be given hard law status in the second instance. An example of such a transformation is the way the Basel accords for banks have been transformed into formal European legislation. Basel III has been the main source for the CRDIV package that forms the basis of the European Banking Union (European Commission, 2013a; 2013b).

For financial institutions, reputation, trust and a good relationship with the regulator and supervisor are very important. Political, social and legal opinions in the EU have evolved in a way that financial institutions are expected to be committed to long-term value creation, sustainable and socially responsible business practices and finance (Sun et al., 2011). Long-term value creation, internal control and compliance with laws and regulations not only to the letter but also to the spirit of the law are priorities that are here to stay (McBarnet, 2010). Just as the tightening of financial supervisory law was aimed at preventing another crisis and increasing the shock resistance and financial health of banks and other financial institutions, ESG legislation is aimed at making financial sectors an active part of responses to climate change, sustainability goals and other pressing social and economic concerns. Leveraging soft law to complement the hard law basis offers a number of distinct advantages. These include the possibility of standardisation and certification by branch organisations. If certain sustainable and green products or services can only be offered after they have been approved by a branch organisation, this will achieve a goal that converges with government objectives in this area.

11.5 Towards Green Corporate Governance

11.5.1 Introduction

Corporate governance basically regulates the relationship between actors within a company, in particular, shareholders, directors and commissioners (Nelemans, 2018). Corporate governance initially took shape in codes of conduct resulting from self-regulation. The formulation of principles and best practices expressed desirable views on good corporate governance. The actions of the management board, supervisory board members and shareholders of companies are standardised in codes, in addition to the

provisions of formal laws and regulations. Governance codes are generally operationalised through the use of the 'comply or explain' principle. The principles of Corporate Governance codes should be considered in conjunction with international, European and national formal laws and regulations, jurisprudence and codes.

Corporate Governance Codes in European member states do, in general, not themselves have provisions dealing with the legal consequences of non-compliance. Non-compliance with corporate governance codes is not threatened with sanctions. A difference can be noted here with the US Sarbanes Oxley Act, especially section four. Research by SEO Economic Research (Conac, 2021; SEO, 2012) shows that in the UK, Germany and Italy, corporate governance regulation is also a combination of public and private regulation. In Ireland, France and Sweden, it is pure private regulation and in the United States public regulation. Monitoring of compliance with corporate governance regulation is exercised in Germany, France, Italy and the United Kingdom, like the Netherlands, by organisations with public and private characteristics. In Ireland and Sweden, a private organisation is in charge of monitoring, and in the United States monitoring is done by a government institution. Supervision and sanctioning do not take place in the Netherlands, Germany, France and Sweden. Ireland has a private supervisor, the United Kingdom a public/private supervisor and the United States and Italy a government supervisor.

11.5.2 Four theories of Corporate Governance

An unequivocal theory of corporate governance cannot be given. Since the development of the principal-agent theory by Jensen and Meckling (1976) three other theories of corporate governance have been developed. Galle (2012) compared and explained the four common theories of corporate governance:

1. In the principal–agent model, the separation of ownership and governance raises problems, as shareholders (principals) depend on the decision-making of directors (agents). The interests and objectives of shareholders do not match the interests of directors at certain points. Shareholders are focused on maximising 'return on investment', both with respect to the value of their shares and dividends, while directors seek high salaries, bonuses or social status.

Classical agency theory focuses on maximising shareholder interests and curbing opportunism by directors.

2. In classical principal–agency theory, shareholders' interests should be maximised and directors' opportunism controlled. Stewardship theory opposes this premise and places more trust in directors. The underlying idea is that people are not only driven by individualistic and opportunistic interests but that collective interests and trustworthiness are also drivers of people. Stewardship theory assumes a more positive approach to executives, with the premise that behaviour that is focused on the collective will be beneficial for organisations and should be preferred to individualistic behaviour focused on self-interest.
3. Corporate governance considered from the perspective of transaction costs economics sees the company as a structure with internal transactions and agreements. Because there are costs associated with using markets and a desire for certainty, contracts are used to optimise these processes and needs. Because of transaction costs, contracts between principals and agents are incomplete and a governance structure is needed to fill in gaps in these contracts.
4. Stakeholder theory is ideologically at the opposite end of the spectrum to principal–agent theory. It takes into account not only the interests of the shareholder but the interests of all stakeholders involved in the company, such as employees, the government and the environment. In the United States and the United Kingdom, corporate governance has traditionally been approached from the interest of shareholders, while in Europe the focus is more on a company's stakeholders; the Anglo-Saxon model vs. the Rhineland model (Sison, 2008; Solomon & Solomon, 2004).

11.5.3 Integrating ESG into the Stakeholder Theory

If one takes the stakeholder theory of corporate governance as a starting point, current and future sustainability and green finance objectives can be projected into it without much hindrance. The governance of financial institutions evolved after the 2008–2012 financial crisis and there is no formal or conceptual limitation that prohibits it from further evolution and incorporating sustainability goals. ESG objectives lend themselves

to integration in corporate governance codes because they allow principles and best practices to be formulated that anchor ESG in the business culture, human resource policy, suitability and fitness criteria for managers, risk management (especially operational and climate risks) and, very importantly, the way in which internal supervision and control are regulated and guaranteed (Luca Riso, 2021). If the annual report, using the comply or explain principle, also explains green corporate governance and how ESG objectives have been met, the market and external regulators can respond and evaluate performance. As is also the case with traditional corporate governance, compliance or problems in this area can have an impact on the share price, market value, competitive position and creditworthiness of institutions. From these viewpoints, ESG and Green Finance lend themselves well to integration into corporate governance systems.

11.6 Integration: Towards Multilevel ESG Regulation

11.6.1 Introduction

Multilevel regulation is not a new phenomenon within the financial sector. International financial regulation largely consists of soft law arrangements, as the issuing institutions do not have formal legislative powers (Mackor, 2018). Within the EU, supranational financial regulation has taken place, especially since the Maastricht Treaty, in the form of directives and regulations. During and after the financial crisis, the European legislator lost some faith in the effectiveness of directives, which is reflected in an increasing use of regulations as a preferred legislative instrument aimed at creating a level playing field in European economic and financial markets (Colaert & Busch, 2019; Moloney, 2014). Alongside the core of hard financial law, there is undiminished scope for soft law and self-regulation. Examples include codes of conduct, disciplinary law, dispute resolution, education and training and self-assessments and reporting.

11.6.2 The Integration of ESG in Multilevel Governance

Green finance and ESG lend themselves well to integration in a multilevel system (Monciardini, 2017), the following arguments can be made for this:

1. there is a need for data and facts on the success or failure of ESG targets. Which measures, investments and market practices have had a positive impact on sustainable and climate-related goals and which a negative one? Legislators and regulators benefit greatly from this data so that policy and supervision can be 'evidence-based' as much as possible. The financial markets are a primary source for this data and the systems needed to collect, process and share this information lend themselves to privatisation and/or public–private partnership.
2. The economic and financial performance of green investments and developing, optimising and possibly making green finance preferable can emerge from sectors bottom-up. As markets and companies move towards standards in sustainable and green investment and business practices, this converges with the objectives of governments and legislators. Self-regulation and soft law arrangements can help set up a system by which a significant contribution can be made, in a way that industry codes, disciplinary law and certification also do.
3. In a system of multilevel regulation, there is room for public–private cooperation and coordination of objectives. If the government, in part, acts in a more horizontal way in partnership with private sectors, fruitful results can emerge from these initiatives. Setting up organisations in which the government and private sectors are both represented, aimed at achieving ESG objectives and high-quality green finance goals, can be a form in which cooperation takes shape.
4. Private cross-border cooperation and exchange of ESG knowledge, networks, best practices and success formulas have the potential to add value compared to strictly national approaches to ESG integration. Such cross-border cooperation should not be hampered by formal rules and should be allowed to develop where opportunity presents itself.
5. The impact of ESG and Green finance regulation on the competitive position (within and outside the EU) and solvency of European companies is valuable information for regulators and legislators and can provide grounds for adapting or strengthening sustainability legislation. Constructive dialogues between financial sectors and the government are important in light of this information exchange.
6. In addition to public laws and regulations, there may be a meaningful role for private law, especially liability law. If the damage caused to the environment and climate becomes apparent and, causally, it can be established who is liable for it, the route of

tort law is open. Companies whose commercial practices or investments cause climate damage would be held liable for this, depending on the national private law of the Member State in question. In particular, collective actions could be envisaged where victims and foundations join together in holding a polluting party liable for the damage (Dooh vs. Shell, 2021).

11.6.3 The Advantages and Vulnerabilities of Multilevel ESG Regulation

First and foremost, within a system of multilevel ESG regulation, effective and efficient action must be taken against abuses such as greenwashing (Rizzello, 2022). This practice leads to unfair competition, undermines ESG objectives and deceives investors, direct stakeholders and society as a whole. The persistent problem of greenwashing will most likely only be effectively addressed through a sufficiently compelling system of supervision, enforcement and sanctions (Nurse, 2022). The temptation to invest in environmentally damaging assets and to assign unjustified green status to assets for accounting purposes is probably too great for some market participants. This should include looking at how legislation on fraud and corruption and economic crimes already contains provisions applicable to failing ESG and Green finance legislation.

An integration of ESG into corporate governance was discussed and the same argument can be made for an integration of ESG and Green finance into traditional prudential supervisory law and integrity supervision. As soon as it becomes apparent for financial sectors that climate risks entail micro and/or macro-prudential risks, this should be anticipated. An example is major climate disasters such as floods and their impact on (re)insurers and banks (Reumers & Nelemans, 2022). If the claims exceed the capacity that an insurer can handle, or a large number of companies go bankrupt, possibly causing banks to default on their loans. Then, apart from serious social and economic damage, there are also prudential risks for financial institutions as a result of a climate disaster. The question of when climate risks can qualify as systemic risks is beyond the scope of this chapter, but merits further investigation (De Sousa, 2022; Hochrainer-Stigler, 2020; OECD, 2022).

It is important for financial companies to know how to act if their own continuity is threatened and solvency and liquidity come under pressure.

If a financial institution comes under pressure, are there possibilities to temporarily relax ESG obligations? This issue needs attention because it represents an unavoidable stance on how integrally and inextricably ESG objectives should be built into companies' financing, governance, products and market practices. This also involves the inevitable question of the competitive relationship between European companies on the one hand and non-European companies on the other, which may be subject to more lenient ESG requirements. What are the options of a financial institution in trouble, when non-green business practices may prove a route to faster recovery of financial health? The role of central banks and a possible sector-funded rescue fund may prove to be viable answers (Baur, 2021; Migliorelli et al., 2020).

11.7 Conclusion

In international financial regulation, soft law has taken a firm foothold. In Europe in particular, the choice has been to transform soft law norms into hard law, combined with the installation of specialised supervisors and the threat of sanctioning for non-compliance. In terms of stability, shock resistance and integrity of European financial sectors, practice has shown this to be a successful legal approach. Within financial supervisory law, not all areas are regulated through hard law. There remains room for regulation through corporate governance, disciplinary law, internal supervision, professional organisations and related self-regulation. The challenge was and remains to identify which issues should be regulated through hard law. In prudential supervisory law, these are liquidity and capital requirements, licensing requirements, transparency obligations, suitability requirements, market behaviour and consumer protection. In the EU, as a response to the climate crisis and pressing social and economic concerns, the traditional spectrum of financial supervision law and regulation has expanded to include sustainability, green finance and ESG legislation. Against this background, this chapter sought to answer the question of which ESG objectives for financial institutions lend themselves to self-regulation and soft law, complementary to the hard law framework.

In a non-ESG setting, the argument can be made that strategy, risk appetite, product development, market-competitiveness, human resources, culture and internal supervision/audits are topics that lend themselves well to self-regulation. Such a dichotomy would also be useful

for a selection of ESG objectives and the furthering of Green Finance, so that the best of both worlds can be achieved. National and European regulators benefit from constructive feedback and reporting from markets and institutions. This information could impact the standard-setting and subsequent integration of ESG into institutions' operations and culture, and the evaluation of whether targets have or have not been met.

The challenges facing a multilevel approach to ESG are not insignificant. Greenwashing understandably gets a lot of attention, as it undermines the status and trustworthiness of ESG and Green Finance initiatives. European legislation aims to effectively identify and combat greenwashing. A robust monitoring system and corresponding sanctions apparatus seem inevitable, especially with regard to those companies that try to use greenwashing to avoid legal and regulatory obligations. Another challenge concerns the imbedding of transparency and taxonomy obligations in relation to already existing extensive financial legislation, especially in the areas of market abuse prevention and competition law. Legislators and regulators on the one hand and private/financial sectors on the other could dialogue with each other to provide an effective and efficient response to these future regulatory challenges. Anticipating potential conflicts between ESG legislation and pre-existing laws as well as the status of ESG compliance in cases of (imminent) insolvency will increase the success and resilience of ESG goals and the realisation of future ambitions.

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