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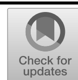

Climate change and financial sustainability: a regulator's perspective

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Abstract Global warming and climate change pose as one of the major, if not the most important political challenges of this century. This keynote speech delivered at the Conference on Climate Change and Sustainable Finance at the Academy of European Law on 6 February 2020 discusses the need for fast political action to mitigate and manage the risk of climate change and the implications for the financial sector. In order to fulfil the emission goals, set out by the Paris Agreement of 2015, the European Union will have to raise additional funds and redirect financial markets towards sustainable investments. The article outlines the challenges political decision makers will have to overcome in order to promote and implement financial sustainability and highlights the initiatives that have already achieved to that end.

Keywords Climate change · European Green Deal · Sustainable finance

Four years after the Paris Agreement on climate was signed pursuant to the 2015 United Nations Climate Change Conference, the picture is rather bleak and confusing. By signing the Agreement, the 197 participating States and the EU had promised to reduce their carbon output "as soon as possible" and to do their best to keep global warming to well below 2 degrees Celsius (aiming at 1.5 degrees).[1] The overall objective was to reduce emissions as part of the method for reducing greenhouse gas. Only two countries have not ratified the agreement, Iran and Turkey, and they only

[1] As stated in Art. 4 of the Paris Agreement to the United Nations Framework Convention on Climate Change, Dec. 12, 2015.

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account for 1% of global emissions. However, in 2017 none of the major industrialised nations had implemented the policies they had envisaged and had not met their pledged emission reduction targets, and even if they had, the sum of all pledges would not keep global temperatures well below 2 degrees. According to the United Nations Environment Programme (UNEP), if we rely only on the climate commitment of the Paris Agreement, temperatures will likely rise to 3.2 degrees this century.[2] To limit global temperature rise to 1.5 degrees, global greenhouse gas emissions must be below 25 gigatons by 2030, whilst with current commitments, they will be 56 gigatons. Global annual emissions would need to be reduced by 7.6% every year between now and 2030. So, let's have a closer look at what has happened in the four main emitters that account for 55% of total emissions in 2018, the last reference point I could find. China was up by 1.6%, the US up 2.5%, the EU down by 1.3% and India up 5.5%.[3] The Paris Agreement has a major flaw in that it is lacking a binding enforcement mechanism. And in November 2019, the US withdrew from the Agreement. If the EU reduced its emissions by half in 2030, this would only represent one quarter of the increase of emissions of China. Not a good picture!

2015 was a key year, with the signing of the Paris Agreement. This was however not the first UN initiative of this kind. In 2000, the UN launched the Global Compact, in 2006 the UNEP established the Principles for Responsible Investment, in 2012 the Principles for Sustainable Insurance, and in 2019 Principles for Responsible Banking. Eight Millennium Development Goals had been established by the UN in 2000, and were replaced by the 17 Sustainable Development Goals (SDGs) in 2015.

In the 2020 Global Risks Report published by the World Economic Forum, which is based on a survey of 800 world leaders and experts,[4] for the first time, environmental threats dominate the top five long term risks by likelihood, and four out of five in terms of impact, which shows that climate change is a systemic issue: One of our missions, as [financial] regulator, is to ensure the safety and soundness of the financial sector, in other words, contribute to financial stability, as climate risk affects this stability in three ways:

Physical risks that arise from the increased frequency and severity of climate and weather-related events;

Liability risks arising from people who suffered a loss due to climate change and seek compensation from those responsible; and

Transition risks arising from a sudden and disorderly adjustment to a low carbon economy. This is the most challenging.

Last year, four NGOs sued the French government for failing to act on its environmental commitments, supported by a petition signed by 2.1 million people.

Neither the State, nor individuals or corporates, will be able to solve the urgent problem we face alone. So, what is needed for meaningful action?

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[2] UNEP Emissions Gap Report 2018, Chapter 3.4.

[3] A detailed analysis of the individual emissions by country can be found in Chapter 2 of the UNEP Emissions Gap Report.

[4] The full report can be found at: https://www.weforum.org/reports/the-global-risks-report-2020.

First, we need a strong political will, with an action plan that is acted upon. A significant commitment was taken at the COP 21 – will it now be acted upon? The United States has withdrawn from the agreement, and others do not reduce their emissions.

Second, we need public and private partnerships and funding.

And thirdly, we need multi-disciplinary teams and experts to solve the complex problems of climate change, but also poverty and other SDGs.

Regarding the political will, international, coordinated action is needed. I have mentioned the Paris Agreement and the limitations thereof. Closer to home, the European Commission has published an Action Plan on Sustainable Finance in March 2018.[5] The EU has reckoned that in order to achieve the EU's 2030 targets agreed in Paris, including a 40% cut in greenhouse gas emissions, we have to fill an investment gap estimated at €250 billion a year. This is beyond the capacity of public spending, and therefore private investment is needed. The financial sector has an important role to play here in re-orienting investments to 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.

In May 2018, the EU Commission adopted a package of measures on sustainable finance, including a proposal for a regulation on the establishment of a framework to facilitate sustainable investment.[6] This includes a unified classification system on what is an environmentally sustainable economic activity, the so-called taxonomy. The second part is a regulation on disclosures relating to sustainable investments and sustainability risks. This is about disclosure obligations on how institutional investors and asset managers integrate environmental, social and governance (ESG) factors in their risk management process. It will be supplemented by requirements to integrate ESG factors in investment decision processes. The third element is a regulation amending the benchmark regulation. There will be a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks, giving investors better information on the carbon footprint of their investments. Timing of all this will of course be key. The European Supervisory Authorities will shortly launch first consultations on technical standards. The non-financial reporting directive will have to be revised. The flow of information will have to be facilitated, and the intention is to create an EU-wide ecolabel and EU green bond standards. The prudential framework may be changed to incentivize sustainable investments, through a green supporting factor. Less capital would be needed for mortgage loans to improve efficiency, or green financing. The von der Leyen Commission's objective is to be carbon neutral by 2050 – Europe would thus be the first continent to achieve this, it is the so-called *European Green Deal*.

In Luxembourg, the first initiative was taken as early as in 2006 with an independent non-profit association called LuxFLAG, founded by seven public and private partners. LuxFLAG aimed at raising capital for the responsible investment sector by awarding a recognizable label to eligible investment vehicles. Today there are five labels in the areas of microfinance, ESG, environment, climate finance and green bonds.

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[5]English version at: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52018DC0097&from=EN.

[6]https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en.

A total 196 products have been labelled with assets in excess of €106.2 billion, from 7 jurisdictions.[7] Another important initiative is the Luxembourg Green Exchange, a sustainable finance platform launched in 2016 by the Luxembourg Stock Exchange. Bonds and funds displayed on the Green Exchange refer to a number of different standards, frameworks, taxonomies and labels.[8] ICMA's Green Bond Principles would be an example.

What can the private sector do? A few years ago, corporates started to have CSR or CR departments. Today it is fair to say that CSR departments are dead, CSR is dead. This was essentially a means to mitigate reputational risk.

As a matter of fact, there should be no distinction between a business strategy and CSR or ESG strategies. We must have sustainability as a strategy. At the same time, we can and should move to creating new income streams and business models. An example is a business model that applies circular economy principles. Companies will need actual, measurable sustainability goals. Who has heard about SMART objectives? The acronym stands for Specific, Measurable, Attainable, Relevant/realistic and Timely objectives. We need an additional word: Sustainability.

Further dimensions are important.

My first point is about money. At the end of the day, all is tied to money and reward, so I am convinced that if we really want executives to change, compensation should also be tied to sustainability objectives. This can be achieved through balanced scorecards or otherwise. A balanced scorecard without sustainability objectives will no longer be balanced.

Second, I have already mentioned reporting and disclosures, and the Commission's plan to revise non-financial reporting. The Financial Stability Board has set up a Task Force on Climate-Related Financial Disclosures that has published final recommendations in 2017, and a first status report in 2018. In 2019 Bloomberg published a report on how many publicly listed companies mentioned climate change in their management calls in 2018, various sectors. For financials the rate was 0.1%. At the same time financials had the biggest market cap by sector (25 trillion USD). There is a long way to go.

Third, shareholder action against managers and fund houses. Just last week, for instance, a £30 billion pool of pension funds threatened to drop asset managers that did not take action on climate change.[9] The Brunel Pension Partnership, which is one of eight pooled local government pension scheme funds in the UK, said it wanted to use its influence to challenge the asset management industry, which it described as not fit for purpose for addressing climate change. Another example would be shareholders in the United States targeting four of the world's largest fund houses, over their record on climate change votes.[10] They have consistently voted against climate

[7] As of Q1 2020: https://www.luxflag.org/media/pdf/Factsheet_LuxFLAG_26032020.pdf.

[8] https://www.bourse.lu/green.

[9] https://uk.reuters.com/article/us-climatechange-funds-brunel/uk-pension-fund-brunel-to-firms-asset-managers-tackle-climate-or-well-drop-you-idUKKBN1ZQ012.

[10] As reported by the Financial Times: https://www.ft.com/content/8aade207-09bc-41a7-9f0a-24417882f1bc.

resolutions, which would ask for more information on how companies would be affected by global warming or call on businesses to outline their plans for transitioning to a low-carbon economy. Pension fund clients want asset managers to step up on climate change, including for instance the world's largest pension fund, Japan's $1 trillion Government Pension Investment Fund.[11]

I will conclude this topic by saying a few words about how the CSSF gets involved in sustainable finance.

We will raise awareness amongst supervised entities about climate risks, all too often ignored or under-estimated. We will use various channels, our web site, circular letters, but also conferences and meetings. The EBA intends to publish a report on including climate risk in the SREP stress testing in June 2021.

On the product side, we participate in a reflection aimed at getting more Luxembourg products sustainable, building on the expertise gained by LuxFLAG and the Luxembourg Stock Exchange. If you look at the fund industry (in excess of €4,700 billion), but also private banking (€400bn) and life insurance (€200bn), we have the capacity and we should have the ambition as a country to make a meaningful contribution to financing the transition to a low carbon economy and the achievement of other SDGs. Regarding the fund industry, as of today, about 2 % of total net assets or €100 billion are invested in sustainable projects, mostly through UCITS. I would caution these figures though in the absence of clear definitions and proper tracking. But in any event, we have room to improve.

An important dimension is financial education. We have a generalist mission in this area, covering diverse areas such as over-indebtedness, education at school and pensions, and have launched various initiatives. Of particular interest is the youth. Our generation has proven inefficient and has failed to act in a timely manner. Words have not been followed by action, often on pressure from lobby groups. The next generation is less willing to accept this and less interested in traditional political party logics and other established structures than in swift action and action that is aligned with promises, commitments and action plans. We should bet on this generation and not only make sure it is financially literate, but that sustainability is factored into financial education from the outset. Education is also needed at investor and corporate level. The investor level educational effort will be part of the Capital Markets Union (CMU). At corporate level, the tone from the top will be key, starting with the board of director, who sets the corporate strategy. Equally important is the C-Suite (CEO/CFO/COO/CRO…), as well as sales and distribution staff. For certain staff involved in investment advice and management, training is mandatory under MiFID 2. Why should training on sustainable investments not be mandatory for certain staff?

All of this means, there is a lot to do, and a lot of positive energy to be deployed. In all this, one should not forget that sustainability is not equal to "not for profit". There are huge opportunities ahead, which hopefully some of you will embrace.

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[11] https://impactalpha.com/japanese-pension-fund-pushes-asset-managers-to-get-tougher-on-sustainability/.