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Sustainable Finance Policy & Regulation: The Case for Greater International Alignment

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Box 1 – Paper in brief

- *Sustainable finance needs a harmonized and sound policy and regulatory framework that ensures clarity of purpose, protects consumers, supports market development, and facilitates transition in key economic sectors.*
- *Given the global nature of the climate change agenda, global leadership is essential to encourage the development of well-aligned and considered regulatory and supervisory frameworks across jurisdictions.*
- *However, signs of fragmentation around climate risk assessment are already evident–notably in the areas of prudential regulation and supervision, market and conduct regulation, taxonomy and disclosure. We would urge policymakers–including the G20, global standard setters and networks such as the NGFS–to consider setting up specific and dedicated mechanisms for greater alignment.*

Overview

Incorporating sustainability considerations into business strategy and risk assessment will offer some of the greatest challenges–and opportunities–the financial sector has ever encountered. To attain the global targets set through the Paris Agreement and the broader United Nations Sustainable Development Goals (SDGs), policymakers have estimated that there is an annual financing gap of $2.5 trillion through 2030.[2] Achieving the Paris Agreement objectives alone would require making 95% of the electricity supply low carbon, 70% of new cars zero emission, and reducing the CO2 intensity of the building sector by 80% by 2050.[3] Meeting these objectives will require investment on a scale not seen since the industrial revolution.

The financial sector thus faces a host of new issues, new demands and new stakeholders. The financial sector clearly will be a catalyst in the transition towards a more sustainable economy. However, emerging policies and

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[2] See https://www.un.org/press/en/2019/dsgsm1340.doc.htm.

[3] See https://www.sciencedaily.com/releases/2019/08/190815113733.htm and https://www.irena.org/-/media/Files/IRENA/Agency/Publication/2017/Mar/Perspectives_for_the_Energy_Transition_2017.pdf.

regulation around sustainable finance[4] are only one element of a broader set of internationally coordinated efforts—including in macroeconomic policy—that will be required to achieve these goals.

Climate (and broader environmental) risk assessment is an innovative and rapidly evolving discipline, raising several important regulatory and supervisory policy questions that require careful consideration. As policymakers and regulators increasingly factor climate risk into their deliberations, the pace at which regulatory proposals have been developed in some parts of the world equals or even exceeds that after the global financial crisis. A new global network—the Central Banks and Supervisors Network for Greening the Financial System (NGFS) was established in December 2017 to share learning on policies; similarly, the Coalition of Finance Ministers for Climate Action (launched in April 2019) will enable ministers to make commitments on key issues, potentially including carbon pricing. The European Union (EU) has developed a comprehensive action plan to integrate sustainability into its financial policy framework,[5] reinforced by the December 2019 European Green Deal growth strategy. Following the EU's example, several other jurisdictions have established green finance strategies[6] or formed expert groups to outline what is needed to achieve a "sustainable" financial sector.[7]

However, the sustainable finance policy landscape is complicated by the fact that there is not yet a global policy framework. Moreover, some key jurisdictions that will be essential to achieving aligned frameworks have been largely absent from the still-emerging global policy and standard setting discussions. The work to date of the standard setters and the NGFS is fundamental and impressive in its scope—particularly given it has occurred in a short period of time. But while the growing focus on climate risk is welcome and appropriate, activity is taking place in various pockets across the traditional international standard-setting organizations—including the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the International Organisation of Pension Supervisors (IOPS)[8]—as well as in the institutions comprising the international financial architecture (e.g. the International Monetary Fund).[9] All this is taking place alongside the work of new groupings outside the normal international economic policymaking apparatus (such as the NGFS and the International Standards Organization[10]). In addition, many countries and regions across the world are developing jurisdiction-specific rules in relation to various aspects of sustainable finance (see **Box 2**).

We very much welcome the increasing coordination among the NGFS and standard setting-bodies, including the newly formed Basel Committee Task Force on Climate-

[4] Sustainable finance can be broadly understood as financing as well as related institutional and market arrangements that contribute to the achievement of strong, sustainable, balanced and inclusive growth, through supporting directly and indirectly the framework of the Sustainable Development Goals (SDGs) (G20 Sustainable Finance Study Group definition, July 2018).
[5] For an overview, see https://ec.europa.eu/info/business-economy-euro/banking-and-finance/green-finance_en.
[6] Green finance strategies are also referred to as green finance roadmaps in some instances.
[7] According to research conducted by ECOFACT for its Policy Outlook there are more than 25 countries working on versions of sustainable finance roadmaps. In addition to the European Commission Action Plan, among the more prominent are the UK, Canada, Australia and Hong Kong. Also see **Box 2**.
[8] For example, see the IOPS statement on integration of ESG factors in investment funds http://www.iopsweb.org/iops-supervisory-guidelines-esg-factors.htm.
[9] For example, see Chapter 6 from the October 2019 IMF Financial Stability Review.
[10] For more information, see https://www.iso.org/committee/7203746.html.

related Financial Risks.[11] Nonetheless, there is growing concern about regulatory and policy fragmentation, which is rapidly becoming a reality at the individual country level. Such fragmentation could result in undesirable complexity and inconsistency of the resulting standards and requirements pertaining to sustainable finance. In a recent IIF-EBF Global Climate Finance Survey of 70 financial institutions,[12] 65% of institutions said that "green" regulatory market fragmentation was a big source of concern and would have a material impact on the market for sustainable finance.[13] Central banks and regulators are themselves concerned about comparability and consistency of the evolving supervisory frameworks with respect to climate risks, as noted in recent OMFIF-Mazars research.[14] The aim of this paper is to highlight examples of fragmentation where it has already emerged, and to suggest ways forward that would increase international alignment.

While the regulatory efforts to date are a helpful starting point, sustainable finance requires the development of a sound global policy and regulatory framework that ensures an aligned path to achieve the SDGs, protects consumers, supports market development, and facilitates the needed transition in key economic sectors. Countries should experiment and retain flexibility to identify the most appropriate approaches for their local legal and market context, but a multiplicity of different approaches to key policy and regulatory initiatives will be at best inefficient and at worst ineffective in supporting the transitions.

Regulatory uncertainty and complexity will impede the ability of the financial sector to mobilize effectively to provide the necessary investment and insurance underwriting for transitioning. A disaggregated and competing approach to policy development in this complex area could affect the quality of the resulting policy frameworks. There is also a risk that activity will migrate to parts of the global financial system that are less stringently regulated or not subject to the same standards.

The IIF urges the G20 to consider an enhanced sustainability agenda that brings together, in a careful and considered manner, key policy discussions across finance ministries, central banks, financial sector regulators/supervisors, and multilateral institutions. Ultimately, sustainable finance is only one part of a broader set of coordinated policies that will be required across the economy, as highlighted in the recent BIS publication *The green swan: central banking and financial stability in the age of climate change*.[15] In particular, policymaking related to sustainable finance should be aligned with other macroeconomic policymaking that will be a necessary part of the transition to a sustainable economy.

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[11] As described in the Basel Committee's February 2020 press release: https://www.bis.org/press/p200227.htm.
[12] IIF-EBF Global Climate Finance Survey: A Look At How Financial Firms Are Approaching Climate Risk Analysis, Measurement and Disclosure (January 28, 2020). Hereafter referred to as IIF-EBF 2020.
[13] IIF-EBF 2020, see Chart 16.
[14] "Tackling climate change: The role of banking regulation and supervision" (February 19, 2020). *"Fragmentation of climate-risk frameworks is deemed a key challenge, with 31% of respondents concerned about the comparability and consistency of supervisory frameworks."* (Page 7.) Report available here: https://www.omfif.org/tacklingclimatechange/. Hereafter referenced as "OMFIF-Mazars 2020 (February)."
[15] BIS/Banque de France 2020 (January), *The Green Swan:* "There is also a role for central banks to be more proactive in calling for broader change. In this spirit, and grounded in the transdisciplinary approach that is required to address climate change, this book calls for actions beyond central banks that are essential to guarantee financial (and price) stability."

With respect to financial sector policymaking, the IIF encourages the FSB and other standard-setting bodies to play a leading role to promote balanced global policy development. The coalition of central banks and supervisory authorities in the NGFS has made a tremendous effort to further thinking on how to analyze and measure climate change risk, and are developing handbooks, including on supervisory practices.[16] We would encourage the NGFS to continue to play a key role as a platform and forum for authorities to exchange views and best practices with regards to climate-related risks for the financial sector and the development of sustainable finance. This could complement any work that is undertaken by the FSB and global standard setters to contribute to considered and balanced policy development over time.

Work could initially focus on climate risks and policies given the growing urgency of that agenda, before turning to broader environmental, social and governance issues. This work could leverage the evolving industry body of knowledge on climate risk. We believe that climate risk assessment should be a collaborative effort between the international standard-setting bodies and the private sector. There are clear shared interests in the sustainable finance agenda and both sectors bring helpful perspectives and resources, with neither having a clear advantage in terms of information or experience. Moreover, both public and private sectors will be held to account by the broader public for progress towards a more sustainable economy. Collaborative efforts would therefore be an efficient and effective way forward. There are already good examples of effective collaboration, such as the private-sector led Task Force on Climate-Related Financial Disclosures (TCFD), which was originally launched by the FSB. The financial industry is ready and willing to engage further with the relevant standard setters, the NGFS, and others to determine efficient and effective ways to develop an appropriate regulatory and supervisory framework for sustainable finance.

The Case for an Aligned Policy Response

Sustainable finance is an important pillar of the transition to a sustainable economy; globally developed and aligned regulatory and supervisory standards will be needed along the way

The value of G20 leadership and FSB oversight has been clearly demonstrated in key global financial sector reforms over the past decade, including the revamping of prudential rules in the capital and liquidity areas, recovery and resolution planning, and OTC derivatives reform. The IIF has previously written about the valuable role of international standards in supporting economic growth and financial stability: international consistency and co-operation contributes to the efficient flow of capital, enhanced competition and efficiency, and reduced systemic risks.[17] We encourage such leadership again from the G20 in this developing area that will ultimately affect nearly all elements of the global financial system.

The risks and opportunities for the financial system are global. The global nature of sustainability is evident: all sectors of the global economy will be affected by coming

[16] So far, it has published a handbook for central banks on sustainable investment, report available here: https://www.ngfs.net/sites/default/files/medias/documents/ngfs-a-sustainable-and-responsible-investment-guide.pdf
[17] See IIF 2017 "International Regulatory Standards: Vital for Economic Growth" (March) and "International Regulatory Standards: renewing and refocusing for future growth" (October).

environmental risk and societal changes;[18] global markets are needed for sustainable finance products; and major financial institutions operate on a cross-border basis. **We believe therefore that sustainability policies, such as those related to climate change, would benefit from a global approach given their intrinsic global nature and relevance.** While recognizing that the international standard-setting community still has a full agenda—including finalizing and evaluating elements of the post-crisis reforms, and addressing new topics such as the digital transformation and crypto-assets—the increasing focus on the climate agenda marks a defining moment for the financial sector—no less than a "fundamental reshaping of finance."[19]

Sustainable finance is cross-sectoral: different types of financial firms will be involved in and affected by the transition—banks, insurers, asset owners and managers, private equity, etc. **The strands of work on this topic are interrelated**—prudential, conduct, taxonomy, disclosure topics and so on. Any regulatory and supervisory standards will thus be required to apply across the system and should be holistic and compatible to achieve their desired outcomes. In some areas, such as prudential requirements or guidelines, somewhat different policy and supervisory responses will be required in different parts of the financial sector. However, this is no different to today's approach to setting global standards—e.g. BCBS design standards for banks, IAIS for insurers, IOSCO for securities and futures markets—so it should still be possible to tailor frameworks accordingly while maintaining high-level alignment.

Globally developed and aligned financial sector regulatory and supervisory standards should enable greater coordination on broader policy efforts, and support more holistic and efficient policymaking. Sustainable finance is only one element of a broader set of internationally-coordinated efforts—including in macroeconomic policy—that will be required to achieve the SDGs.

A global policy response should acknowledge different perspectives on sustainability topics, including regional differences, and accommodate these where possible

While global discussion and harmonized policy development would be beneficial in this area, there is scope to accommodate different perspectives and views on sustainability issues across countries. For example, BCBS banking standards have evolved to comprise 'three pillars' of (1) global minimum standards, (2) supervisory review and (3) market discipline. National authorities are enabled to take further actions to address outstanding risks under Pillar 2, and Pillar 1 itself includes national discretion and options to accommodate different market and industry characteristics at the national level. In addition, elements of the BCBS framework were conceived with proportionality in mind—for example, BCBS standards are intended for large globally-active banks, and they often contain simpler alternative approaches for relatively smaller and simpler banks as alternatives to more complex approaches, e.g. to calculating capital requirements.

Similar design principles could be applied to global sustainable finance regulation and policy. Learning from other jurisdictions and building on best practices (as the NGFS platform

[18] Although some more than others, and some will be more exposed to transition risk or physical risk. See UNEP-FI's "Changing Course: a comprehensive investor guide to scenario-based methods for climate risk assessment, in response to the TCFD" (October 2019).
[19] See for example "A Fundamental Reshaping of Finance" a open letter from BlackRock Chairman and CEO Larry Fink to other CEOs.

is facilitating) can prevent regulatory fragmentation globally. In some cases, the legal environment of a country may influence the approach taken. For example, some countries prefer a more principles-based approach, while others favor a more rules-based approach. However, there are some areas (e.g. disclosure) where more harmonized approaches may be helpful both from an efficiency and effectiveness perspective.

There are some examples of global policy development in the Environmental, Social and Governance (ESG) space that recognize regional variation. For example, in 2019 IOSCO developed a general *Statement on Disclosure of ESG Matters by Issuers*[20] in relation to the objectives and principles of securities regulation. In the same year, IOSCO produced a complementary report on *Sustainable Finance in Emerging Markets and the Role of Securities Regulators.*[21]

Current and emerging sources of fragmentation

Given growing recognition of the importance of action to make economies sustainable, several jurisdictions have been moving ahead to design and implement a range of policies. **Box 2** contains a high-level overview of the pace and trends in global sustainable finance policy and regulation.

In some emerging areas of financial policy, jurisdictions are taking a range of approaches. In this section we highlight some of these divergences across the following branches of financial sector policy:

A. Prudential Regulation and Supervision
B. Market and Conduct Regulation and Sustainable Finance Taxonomy
C. Reporting, Disclosure and Accounting Standards

[20] IOSCO 2019 (January), the report can be found here: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD619.pdf.
[21] IOSCO, The Growth and Emerging Markets Committee 2019 (June), the report can be found here: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD621.pdf.

Box 2: Overview of global sustainable finance policy and regulatory developments

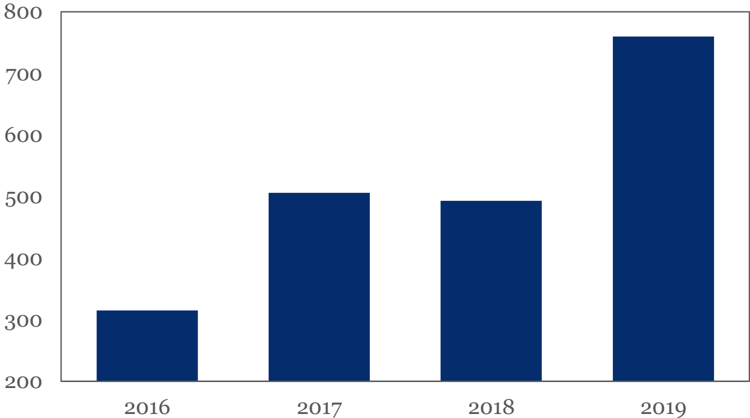
The pace of new sustainable finance hard and soft rule making has been increasing in recent years, and the number of regulatory developments related to the SDGs reached an unprecedented level in 2019 (**Chart B.1**). The rule-making processes put into motion during 2019 by national and international regulatory bodies will continue to progress through 2020.

In 2016, risk management requirements were one of the more common types of regulatory development but, in more recent years, data reflects that new regulation related to ESG integration and non-financial reporting have become relatively more prevalent. Product and service information and labelling – including the development of taxonomies – have been rising quickly in importance since 2016.

According to projections based on ECOFACT's Policy Outlook historic data, it can be expected that regulatory developments related to sustainable finance in 2020 will surpass preceding years. For example, as of January 2020, there are more than 25 countries working on sustainable finance roadmaps, also called sustainable finance strategies in some contexts. A cross-jurisdictional analysis of such initiatives unveils signals of upcoming regulatory developments, such as the:

- introduction of disclosure obligations aligned with the recommendations of the FSB's TCFD;
- adoption of sustainable finance taxonomies;
- development of environmental and social risk management standards; and
- support for green bonds and green lending strategies.

Chart B.1 - Sustainable Finance Regulatory Developments
number of sustainable finance regulatory developments relating to the SDGs



Source: ECOFACT

Chart B.1 notes:

(a) Chart shows regulatory developments across the broad range of sustainable finance measures relating to the SDGs, i.e. not only focused on climate-related topics.

(b) Regulatory development is any relevant policy development, such as submission of initial regulatory proposal, consultation periods, parliamentary debates, and entry into force of a given law.

Source: Policy Outlook (ECOFACT)

Policy Outlook, a continuously updated research package focusing on hard and soft law initiatives pertaining sustainable finance and corporate responsibility issues. For further information on the Policy Outlook, please contact policy@ecofact.com.

A) Prudential Regulation and Supervision

Climate risk and broader environmental and sustainability issues should be incorporated into the prudential framework for banks, insurers and investment firms in a considered manner given that they can potentially materialize as financial risks (credit, market, operational) for individual firms, which can in turn affect firm viability (relevant for microprudential regulation) and system-wide stability (relevant for macroprudential regulation).

Considering this, we appreciate the resources being devoted to exploring and further understanding the risks and developing analytical risk assessment methodologies as illustrated by the recent research published in individual central bank financial stability reports as well as by the BIS[22], the IMF[23] and the NGFS[24]. These efforts are contributing to a rapid development of a common knowledge base, which will support both public and private sector efforts.

However, a variety of approaches is already emerging in relation to prudential topics including both the development of risk management guidelines and analytical exercises (i.e. scenario analysis or stress testing).

Risk management guidelines

With respect to risk management guidelines, some supervisors have focused on climate risks (e.g. the UK PRA Supervisory Statement[25]), some on environmental risks (e.g. the HKMA greenness framework[26] and the MAS environmental risk management guidelines[27]) and some on broader sustainability topics (e.g. BaFin sustainability risk management guidelines[28] and a Brazilian Central Bank legal resolution addressing financial institutions' policies and systems related to ESG matters[29]).

While the risk management guidelines often focus on similar topics (e.g. governance, risk appetite and measurement, reporting) they are adopting different implementation tools such as accountability requirements, incorporation into remuneration frameworks and development of rating systems. Moreover, international organizations including the OECD have ongoing workstreams on related topics such as ESG due diligence[30]; care should be taken that these efforts are aligned with related guidance from the global standard setters.

The variety of approaches and tools, and differences in the scope of application of these initiatives, are making it difficult for firms to develop consistent, efficient, and ultimately effective risk management frameworks. This is challenging as many firms are currently investing significantly in incorporating explicit processes for identifying and assessing climate-

[22] See various articles in BIS Quarterly Review, Speeches and FSI paper series as well as the BIS/Banque de France *Green Swan* publication.
[23] See https://www.imf.org/en/Topics/Environment.
[24] NGFS and NGFS member publications can be found here: https://www.ngfs.net/en.
[25] See https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319.
[26] See https://www.hkma.gov.hk/eng/key-functions/banking/banking-regulatory-and-supervisory-regime/green-and-sustainable-banking/.
[27] See https://www.channelnewsasia.com/news/business/mas-to-issue-consultation-paper-on-environmental-risk-management-12391144.
[28] See https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2019/meldung_191220_MB_Nachhaltigkeitsrisiken_en.html.
[29] See http://unepinquiry.org/wp-content/uploads/2016/09/10_Greening_Banking_Policy.pdf.
[30] See https://www.oecd.org/investment/due-diligence-guidance-for-responsible-business-conduct.htm.

related risks and opportunities into their internal risk management frameworks. For example, 45% of the 70 global participants in the recent IIF-EBF Global Climate Finance Survey stated that such processes are already a part of their risk management framework.

The absence of an international standard or guidelines (as exists for other key supervisory topics) appears to be leading to a high level of experimentation at the national level that can lead to or exacerbate fragmentation. We would encourage standard-setting bodies such as the BCBS, the IAIS and IOSCO to discuss and ultimately develop appropriate risk management guidelines, focused in the first instance on climate change risks, to move away from the current situation in which several jurisdictions are adopting their own approaches. Towards this end, we believe that developing effective risk assessment and management practices could be carried out as a valuable collaborative effort between the standard-setting bodies and the private financial sector.

Climate-related scenario analysis exercises for supervisory purposes

The scope and approaches that national authorities are currently pursuing in climate-related scenario analysis differ widely, even though a number of authorities have committed to base their exercises on scenarios that the NGFS is expected to release later this year. Some authorities are moving straight into detailed quantitative exercises covering both banks and insurers (such as the Bank of England) while others are starting with data collection and research efforts before running exercises (see for example, the European Banking Authority[31] and the Bank of Canada's multi-year research plan[32]). Some jurisdictions (e.g. the Netherlands,[33] UK[34], Australia[35], France[36]) have already conducted or are planning to run exercises for both the banking and insurance sectors. Other jurisdictions have so far focused primarily on specific sectors (e.g. Singapore has analyzed insurance[37]; Denmark is proposing to focus on credit institutions[38]).

Within the exercises themselves, there are also key design differences. Some propose to focus on multi-decade time periods (e.g. 30 years or even through 2080 in the case of the Bank of England) while others are focused on a shorter range (e.g. the five-year period between 2017 and 2023, in the case of the Netherlands[39]). Some authorities are considering three scenarios[40], while the NGFS themselves have so far proposed a four-scenario

[31] See https://eba.europa.eu/eba-pushes-early-action-sustainable-finance.
[32] Announced in November 2019: https://www.bankofcanada.ca/2019/11/researching-economic-impacts-climate-change/.
[33] In their 2019 analysis, the Dutch National Bank also analyzed pension funds.
[34] See https://www.bankofengland.co.uk/-/media/boe/files/paper/2019/the-2021-biennial-exploratory-scenario-on-the-financial-risks-from-climate-change.pdf.
[35] See https://www.reuters.com/article/us-australia-climatechange-banks/australia-plans-new-bank-stress-tests-to-assess-climate-change-impact-sources-idUSKBN2042BC.
[36] See https://www.reuters.com/article/us-france-climate-finance/france-to-stress-test-banks-insurers-climate-risks-next-year-idUSKBN1Y30CS.
[37] In a 2018 industry-wide stress test, the Monetary Authority of Singapore subjected insurers to a scenario featuring extreme flooding; insurers had to consider the impact of higher claims on their balance sheets arising from damage to insured properties.
[38] See https://www.ngfs.net/sites/default/files/media/2019/12/12/analysis_no_26_climate_change_can_have_a_spillover_effect_on_financial_stability.pdf.
[39] See https://www.dnb.nl/binaries/OS_Transition%20risk%20stress%20test%20versie_web_tcm46-379397.pdf
[40] For example, the Bank of England proposes three scenarios in a Discussion Paper on climate-related stress testing (December 2019).

framework.[41] Some focus on the entirety of balance sheets while others propose a more proportionate approach and focus on key climate-sensitive assets and liabilities only—i.e., emphasizing materiality. Thus, it is clear that even if the NGFS provides standard scenarios, there may be significant divergence in how they are used.

There are also emerging differences in analytical approaches: some exercises are focused on traditional bottom-up credit analysis (e.g. as in the UNEP-FI TCFD pilot project for banks[42]) while other exercises have taken top-down perspectives or are adopting emerging "alignment" measures (e.g. leveraging the 2 Degrees Investing Initiative and its Paris Agreement Capital Transition Assessment[43]). While specialized service providers continue to develop new approaches to combine top-down and bottom-up analysis to estimate the temperature alignment of financial institutions' asset holdings (e.g. MSCI Climate Value-at-Risk,[44] Trucost Carbon Earnings at Risk[45]), existing methodologies differ in depth, scope and asset coverage.

While experimentation is understandable in an area that is new—and indeed firms are starting to test a number of scenarios as part of their own internal risk management (see the January 2020 IIF-EBF survey for a snapshot of the industry activity)[46]—in a supervisory context, if a variety of approaches is taken it will make comparability very difficult. Such experimentation at the national supervisory level will also present specific level playing field challenges to firms that partake in multiple exercises, such as banks and insurers that operate across borders and are subject to regional or host-required stress testing exercises as well as home-required exercises. The IIF is concerned about a repeat of the post-crisis experience with capital adequacy stress testing—where different approaches emerged rapidly, creating not only inefficiencies but an inability to compare results across key jurisdictions and some skepticism about the outcomes of the exercises. Indeed, costly fragmentation in capital adequacy stress testing continues to exist today, as recently observed by the Financial Stability Institute.[47] It is extremely important to avoid such "apples and oranges" outcomes, particularly in the case of any disclosed climate scenario analyses or stress tests, which could generate a complex and potentially misleading public narrative.

Accordingly, climate change risk analysis and measurement would benefit from a high degree of interaction between industry and regulators. This is particularly important given data limitations, timeframes involved, and methodological uncertainties. The IIF would encourage a more global approach to analysis exercises—ideally in collaboration with industry—to cultivate a common baseline in terms of approaches and framework with a view to meaningful and comparable results. In addition, the standard-setting bodies common and/or NGFS could develop global exercises, akin to the BCBS Quantitative Impact Studies (QIS) that have been performed in relation to the bank capital framework since 2001.[48]

[41] As set out in NGFS Comprehensive Report 'A call for action: Climate change as a source of financial risk' (April 2019) and summarized in a December 2019 Bank of England Discussion Paper on climate-related stress testing (see Box 2, Figure 3.2)
[42] See https://www.unepfi.org/banking/tcfd/.
[43] See https://www.transitionmonitor.com/.
[44] See https://www.msci.com/documents/1296102/16985724/MSCI-ClimateVaR-Introduction-Feb2020.pdf.
[45] See https://www.spglobal.com/en/Perspectives/IIF-2019/Trucost-Carbon-Earnings-at-Risk.pdf.
[46] IIF-EBF 2020.
[47] FSI 2020. Convergence in the prudential regulation of banks - what is missing? (February 4).
[48] For a history of BCBS impact studies, see https://www.bis.org/bcbs/qis/overview.htm and https://www.bis.org/bcbs/qis/.

Interactions with microprudential requirements

Discussions are already emerging about whether and how to reflect climate-related risks in financial firms' capital requirements. For example, the European Commission and the European Parliament have discussed the introduction of a "green-supporting factor" to reduce capital requirements for financial firms with lower exposure to climate-related risks.[49,50] Similarly, there have been proposals for a "brown-penalizing factor" to increase capital requirements for firms with greater exposure. There are emerging examples of national authorities introducing 'green preferential' capital requirements, such as the Hungarian Central Bank (MNB) which has introduced a time-limited capital requirement deduction for loans serving energy efficient homes.[51]

As noted in the above-mentioned BIS *Green Swan* publication, additional research is required on the costs and benefits of taking either approach.[52] Moreover, the recent OMFIF-Mazars survey indicates mixed views among central banks on the use of microprudential tools (such as adjustments to capital risk weights) to try to channel private funding to address climate change issues.[53] Andrea Enria, Chair of the Supervisory Board of the ECB, has commented that: *"any capital relief for green assets must be based on clear evidence that they are less risky than non-green assets."*[54] It is important that any such analysis and debate is conducted at the international level with due process and consideration by standard-setting bodies such as the BCBS, IOSCO and IAIS that have the necessary expertise and reach. It is also fundamental that prudential standards for capital and liquidity remain appropriately risk-sensitive and focused on their primary objective of financial system resilience.

B) Market and Conduct Regulation and Sustainable Finance Taxonomy

Market and Conduct Regulation

There has been rapid growth in the market for sustainable finance-related products and an evident desire to integrate ESG issues into investment management and financing activities in a careful way (**Table 1**). The market has developed a range of standards governing green, social and sustainability bonds as well as green and sustainability-linked loans over the past few years (e.g. ICMA's Green Bond[55] and Green Loan Principles[56]). These market-based principles have provided useful frameworks and allowed for innovation in an emerging field. Moreover, the private sector is also taking steps to develop and support evolving market standards—not only the Green Bond and Green Loan Principles, but also initiatives such as the International Finance Corporation's Operating Principles for Impact Management (developed

[49] For more on the "green-supporting factor," see the Action Plan on Sustainable Finance adopted by the European Commission in March 2018.
[50] The First Comprehensive Report of the NGFS published in April 2019 also mentions the concept of integrating climate-related risks into quantitative aspects of the prudential framework.
[51] Introduced in December 2019. For more information see this English translation from the MNB: https://www.mnb.hu/letoltes/notice-preferential-green-capital-requirement.pdf.
[52] Outstanding questions include how to categorize assets as 'green', 'brown' or otherwise; whether and how environmental-related categorization is statistically associated with financial performance and riskiness; and the real economic impact of adjustments to capital risk weights on different types of lending.
[53] OMFIF-Mazars 2020 (February). For example, see Figure 7 based on a survey of 33 central banks and regulatory authorities.
[54] Enria 2020. 'Regulation, proportionality and the sustainability of banking', speech (November, 21).
[55] ICMA's Green Bond Principles: https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/
[56] The Green Loan principles, a collaboration between ICMA, the Loan Market Association, APLMA, and LSTA, can be found here: https://www.lma.eu.com/application/files/9115/4452/5458/741_LM_Green_Loan_Principles_Booklet_V8.pdf.

in consultation with leading asset managers, asset owners, asset allocators, development banks, and financial institutions)[57] as well as recent proposals to clarify and rationalize sustainable investment terminology.[58]

At the same time, the regulatory approach to market and conduct standards has been developing, with different jurisdictions taking considerably different approaches. Some (e.g. the EU[59]) have chosen to rigorously define expectations throughout the investment chain, including detailed disclosures. Others (e.g. the Hong Kong Securities and Futures Commission[60]) have sought to bring greater transparency to the market while also reinforcing existing conduct standards. Some supervisors (e.g. the UK FCA[61]) have signaled an increased focus on the green market but without setting new rules yet. Finally, some jurisdictions (e.g. the U.S.) seem keen to leave it to the market to develop and enforce its own standards. It is important to note that the principles of many existing market and conduct standards will relate to sustainable finance-related products as they do to other, existing financial products. For this reason, any bespoke standards for sustainable-finance related products should be developed on an as-needed basis.

Table 1: *The universe for sustainable bonds and loans is fast approaching $1.5 trillion*

Outstanding sustainable debt and loans
as of February 19, 2020
$ billion

Sustainable debt securities	**916.3**
Green bonds	660.9
Green ABS	84.7
Sustainability Bonds	77.1
Social bonds	47.5
Green muni bonds	42.1
Sustainability-linked bonds	4.0
Sustainable loans	**538.2**
Green loans	356.0
Sustainability-linked loans	182.2
Total	**1454.5**

Source: Bloomberg, IIF's Green Weekly Insight

Given the variety of public and private sector approaches that are emerging, we would encourage the FSB and the global standard-setting bodies to take stock of and track developments with a view to building on market-led initiatives and considering whether and how to adapt existing market and conduct standards for sustainable finance.

Sustainable Finance Taxonomy

Establishing a taxonomy—a common classification or definition of what assets and activities serve (or do not serve) sustainability objectives—is often cited as a pre-condition for ensuring confidence in sustainable finance and achieving sustainability outcomes. In a 2017 report, the OECD noted that "convergence towards commonly accepted definitions will be essential to maximize the effectiveness, efficiency and integrity of the market."[62] On that basis, taxonomy will become a foundational element of other policy work including risk measurement and disclosure. Successful implementation of a taxonomy framework by policymakers—and the adoption of this common language by the market—will be crucial both to growing the market

[57] See https://www.impactprinciples.org/.
[58] See for example the November 2019 IIF Discussion Paper, "*The Case for Simplifying Sustainable Investment Terminology*" and The Investment Foundation's "*Responsible Investor Framework*".
[59] See https://ec.europa.eu/commission/presscorner/detail/en/IP_19_1571.
[60] See https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=19EC18.
[61] See https://www.fca.org.uk/publications/feedback-statements/fs19-6-climate-change-and-green-finance.
[62] OECD 2017. *Mobilising Bond Markets for a Low-Carbon Transition, Green Finance and Investment* (April 19).

for green finance, greening the broader market for finance and avoiding the risk of "green washing".

The IIF supports the efforts to give further clarity to the market on what is considered green or sustainable finance. However, work on a taxonomy is already underway at a national level (e.g. China[63], Canada[64], Malaysia[65]), regional level (most notably the EU Taxonomy[66] and International Platform[67]), and multilateral level (e.g. Multilateral Development Banks' Common Principles for Climate Mitigation Finance Tracking,[68] and the International Standards Organization Technical Committee 322 Sustainable Finance standard[69]). While the energy behind such efforts is commendable, this scattered approach creates a significant risk that multiple, diverging taxonomies will emerge. Fragmented outcomes would hinder comparability and inhibit market and policy development. As experienced during the roll-out of the OTC reforms and aspects of MiFID (e.g. research), different approaches can result in undesirable fragmentation of markets that reduces market activity overall. Taking a fragmented approach to climate or broader sustainable finance topics would be deeply regrettable at a time where there is an urgent need to accelerate financial flows that support the transition to a sustainable economy.

The current approach also makes it difficult to understand where the industry can or should engage. Given that the industry will need to use the taxonomies that are developed, it is important for all of the different parts of the financial sector (banks, institutional investors, insurers etc.) to understand what underlies them, how they are being developed and to work with the emerging standards to best determine how they can be integrated into existing market infrastructure.

It is important to drive as far as possible towards an aligned and internationally consistent taxonomy, potentially with some national/regional variations. As seen in the area of cyber security,[70] fragmented taxonomies can impede policy implementation and should be avoided. At this stage, building on existing practices currently being used by market participants would be preferable to creating entirely new taxonomies. And any new initiatives should help align the existing taxonomies and definitions in the market. Finally, taxonomies will need to recognize that many sectors and economies are in transition and thus there may need to be "shades of green".[71]

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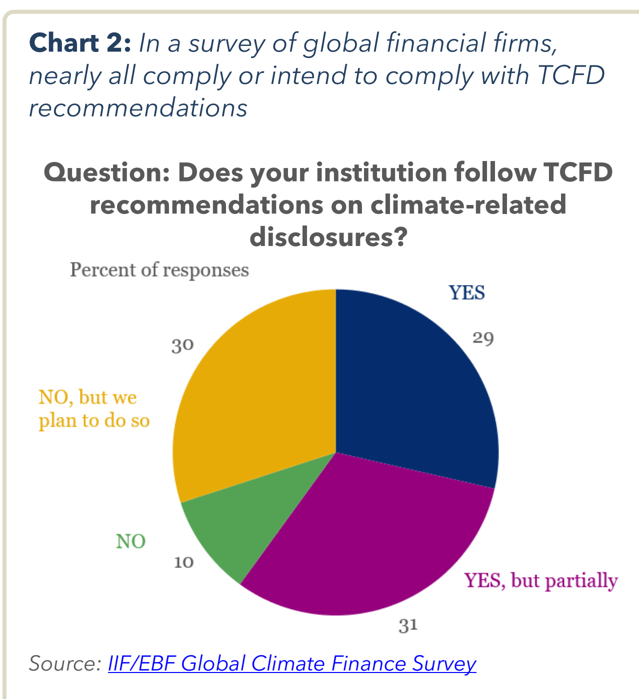
[63] See China's Green Bond Endorsed Project Catalogue (2015); also http://www.gov.cn/fuwu/2019-03/08/content_5371892.htm.
[64] See https://www.responsible-investor.com/articles/canada-moves-ahead-on-creating-green-taxonomy-for-resource-heavy-economies.
[65] See https://esgclarity.com/malaysia-targets-green-taxonomy/.
[66] See https://www.consilium.europa.eu/en/press/press-releases/2019/12/18/sustainable-finance-eu-reaches-political-agreement-on-a-unified-eu-classification-system/.
[67] See https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en#ipsf.
[68] See https://www.worldbank.org/content/dam/Worldbank/document/Climate/common-principles-for-climate-mitigation-finance-tracking.pdf.
[69] See https://www.iso.org/news/ref2469.html.
[70] The FSB has created an internationally agreed lexicon resulting from its emphasis on the importance of cross-sector common understanding of relevant cyber-security and cyber-resilience terminology.
[71] Mark Carney in a December 2019 article for the IMF's Finance & Development said, "Mainstreaming sustainable investment calls for a richer taxonomy—50 shades of green."

Thus, the IIF would welcome one clear center of activity to coordinate taxonomy efforts—ideally with participation from both public and private sector actors.[72] Whether the end result is convergence on a global taxonomy or (at a minimum) greater alignment on taxonomies, such a center—for example, the FSB—would greatly facilitate effective implementation of taxonomy into the market.

C) Reporting, Disclosure and Accounting Standards

Disclosure requirements are both a means to an end and an end in themselves. As noted in the recent IIF-EBF survey,[73] the industry continues to make progress in implementing the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). In a global survey of 70 financial institutions, around 60% of respondents comply fully or partially with TCFD recommendations and a further 30% plan to comply soon (**Chart 2**). The continued sponsorship of TCFD by the FSB is valuable and constitutes a signature example of how the industry believes sustainable finance regulatory and supervisory standards should be developed.

Chart 2: *In a survey of global financial firms, nearly all comply or intend to comply with TCFD recommendations*



Source: IIF/EBF Global Climate Finance Survey

However, to facilitate the ability of the financial sector to meet many of the prudential and market standards discussed above, their corporate counterparties must also provide high quality, comparable, consistent and complete disclosures, which is not currently the case across the board (**Chart 3**).[74] While TCFD is an important part of these efforts, it will be essential to build on the TCFD framework and develop a more detailed but dynamic template for what good disclosure looks like. Towards this end, the IIF is seeking to develop such a disclosure template in H1 2020 in collaboration with our member firms and other initiatives focused on TCFD implementation, including the UNEP FI Pilot Project[75], Sustainability Accounting Standards Board (SASB)[76] and Climate Disclosure Standards Board (CDSB)[77].

However, beyond the TCFD—and particularly for sustainability topics outside of climate—there is a need for further alignment around the current wide range of both voluntary and

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[72] In September 2019, in a letter to the EU, the IIF set out some principles that could guide the development of a sustainable taxonomy, available at: https://www.iif.com/Publications/ID/3563/Letter-on-EU-Sustainable-Finance-Taxonomy-to-the-EC-TEG. For example, the principles include taking a flexible approach (accounting for the different status and speeds among countries, and local adaptation) and a more holistic approach (encompassing and supporting all transition activities).

[73] IIF-EBF 2020.

[74] For more information about firms' ESG reporting practices, refer to the IIF Green Weekly Insight (February 27, 2020): https://www.iif.com/Publications/ID/3776/Green-Weekly-Insight-The-Race-for-Better-ESG-Disclosure

[75] See footnote 42.

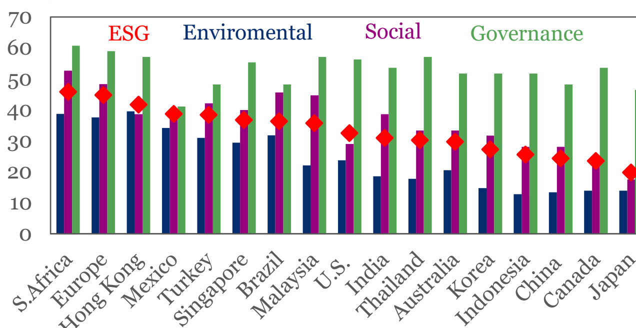
[76] See https://www.sasb.org/standards-overview/.

[77] See https://www.cdsb.net/.

mandatory reporting initiatives as well as accounting standards. For example, there are several reporting frameworks in existence, e.g. those produced by SASB, the Global Reporting Initiative (GRI)[78] and others.[79] A number of initiatives have been working to promote such alignment, including the Corporate Reporting Dialogue,[80] which has convened many of these industry-led standards. The recent report *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*,[81] a private sector effort prepared for the 2020 World Economic Forum (WEF) and supported by the four major accounting and audit firms, may provide a foundation for further work. In general, as noted in the WEF report, a systemic solution would be the emergence of a generally accepted international sustainability accounting standard.

Chart 3: *ESG reporting on key performance indicators remains limited. Even governance disclosure remains largely incomplete.*

index, median, a score of 100 means that the firms disclose every data point collected by Bloomberg



*Source: Bloomberg, IIF; *based on firms listed in the benchmark stock exchanges; find IIF's Green Weekly Insight source report at this link.*

It will be necessary for efforts at alignment to have clear sponsorship and ideally support from international standard-setting bodies and recognition by the audit community. The IIF would encourage the G20, FSB (building on the efforts of the TCFD and other industry-driven initiatives), accounting standards boards (IASB and FASB) and those initiatives involved in the Corporate Reporting Dialogue, as well as the relevant prudential standard setting-bodies[82] to promote alignment and consolidation in the area of sustainability reporting. This could focus initially on climate-related disclosures, but be framed to facilitate expansion to broader ESG disclosures including natural capital (defined as the stock of ecosystems that yields a renewable flow of goods and services that underpin the economy and provide inputs and benefits to businesses and society).[83]

The value of a 'single set of high-quality global accounting standards'[84] has long been recognized: G20 leaders called for such convergence at the 2009 Pittsburgh summit. This takes on a new meaning in the context of sustainability reporting and disclosures. Given the

[78] See https://www.globalreporting.org/standards/.
[79] See Appendix 3 of February 2020 report by the European Financial Reporting Advisory Group (EFRAG) for a list of standards and frameworks used by various large companies for climate-related reporting.
[80] For more information, see https://corporatereportingdialogue.com/about/.
[81] White paper available here: https://www.weforum.org/whitepapers/toward-common-metrics-and-consistent-reporting-of-sustainable-value-creation.
[82] The IAIS, in collaboration with the UNEP Sustainable Insurance Forum (SIF), consulted between December 2019 and February 2020 on issues related to TCFD recommendations for insurers. Read the IIF response to the Issues Paper here.
[83] Natural capital definition from the UNEP-FI Natural Capital Finance Alliance (NCFA): https://www.unepfi.org/ecosystems/ncfa/.
[84] See the G20 Leaders Statement at the Pittsburgh Summit, 2009 (September 24-25): https://www.oecd.org/g20/summits/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf.

relative novelty of this field, it should be more feasible to promote convergence and alignment in relation to sustainable accounting, reporting and disclosure standards.

Conclusions:

While the regulatory efforts to date are a helpful starting point and the energy behind them commendable, sustainable finance needs a globally harmonized and sound policy and regulatory framework that ensures clarity of purpose, protects consumers, supports market development, and facilitates transition in key economic sectors.

Given the global nature of the climate change agenda, global leadership is essential to encourage the development of well-aligned and considered regulatory and supervisory frameworks across jurisdictions.

Signs of fragmentation around climate risk assessment are already evident—notably in the areas of prudential regulation and supervision, market and conduct regulation, taxonomy and disclosure. We would urge policymakers—including the G20, global standard setters and networks such as the NGFS—to consider setting up specific and dedicated mechanisms for greater alignment.