SwissFinanceCouncil
Fostering International Dialogue

SUSTAINABLE FINANCE: TOWARDS A CARBON NEUTRAL EUROPEAN ECONOMY

KEY TAKEAWAYS

Accelerated by the COVID-19 pandemic and surge in investor demand, sustainable investing is set to become mainstream. Financial institutions grasp new opportunities by advising private investors in anticipation of the generational wealth shift and accompanying corporates' transition towards more sustainable business models. While important barriers and challenges remain, the financial sector can only do as much to catalyse the climate change mitigation policies. To reorient capital flows to sustainable activities, markets will need predictable regulatory frameworks with a robust carbon pricing system and clear transition pathways. Maintaining and creating open markets, closing data gaps and achieving global regulatory alignment are among the key prerequisites for a success of the sustainable finance policy agenda.

COVID-19 Recovery: An Opportunity for Structural Change?

With the increasingly visible impacts of climate change, mitigation of global warming has ranked among the top priorities of policymakers and regulators across the globe. The pressure to reinforce the resilience of our economies, including the financial sector, in that regard is significant. Policymakers are considering not only financial institutions' exposures to environmental, social, and (corporate) governance (ESG)-related risks, but also the role they can play in driving the recovery and catalysing the transition towards a climate-neutral economy.

"Economic recovery from the pandemic is an opportunity to promote and set the right incentives for building the sustainable economy of the future."

Peter Derendinger, SFC Chairman

The COVID-19 pandemic seems to have strengthened the determination in relation to such a policy shift and it certainly increases the relevance of ESG considerations with adequate incentives embedded in public recovery plans. At the same time, the broad consensus suggests that demand for sustainable financial instruments is growing. Having this in mind, the external shock of the pandemic can also be an impetus of structural changes in our economies and stimulate innovation in financial markets.

Ambitious frontloading of climate change mitigation and adaptation policies could make radical policy and regulatory changes in the future less likely. To prevent abrupt revaluation and dislocation of assets across regions and sectors, markets and industries demand a predictable and credible regulatory framework with a clear policy strategy on transition pathways.

Climate Change Mitigation and Sustainable Finance: Europe as a Leader

The European Union (EU) has been leading the regulatory response to climate change as well as the broader sustainability challenges globally with its efforts to put a price on CO2 emissions and to accelerate progress towards the Green Deal 2050 climate neutrality target.

The pandemic recovery fund is set to boost the green debt markets with EUR 225 bn in EU Green Bonds, while the new EU Social Bond Framework will help to channel funds towards Member States' short-term unemployment schemes. The European Central Bank (ECB) also signalled its openness to discuss the integration of sustainability considerations within its monetary policy operations and broadened the universe of the Eurosystem-eligible marketable assets to include Sustainability-Linked Bonds (SLBs). Building on the Sustainable Finance Taxonomy and the investors' Disclosure Regulation, new measures envisaged under the forthcoming EU Renewed Sustainable Finance Strategy are expected to equip the financial sector with further tools to support companies on their transition towards more sustainable business models.

The International Platform on Sustainable Finance (IPSF) set up by the European Commission endeavours to ensure international convergence of taxonomies and disclosure rules building on the EU example. The upcoming review of the Non-Financial Reporting Directive will be crucial in closing the corporate data gap and thereby to incentivise and enable capital reallocation.

While the financial sector is key to support and enable the transition towards a sustainable economy, financial market policy should not be used to try to correct market failures in other sectors or be seen as a substitute for other policy measures.

Sustainable Finance and Capital Markets Union: Twin Objectives

In the period 2021 – 2030 the EU will invest, on an annual basis, EUR 350 bn more than during the period 2011 – 2020 to achieve its new targets (to cut greenhouse gas emissions by 55% compared to 1990 levels by 2030). This represents an annual increase of approximately EUR 90 bn compared to the investments needed to achieve its previous 2030 targets (to cut greenhouse gas emissions by 40% compared to 1990 levels by 2030).[1] Given the enormous investment needs, global capital markets play an indispensable role in mobilising and redirecting private and institutional capital towards the modernisation and decarbonisation of the European economy. Moreover, shareholder engagement and stewardship on ESG issues through equity investment will also play an instrumental role in driving the societal shifts, as the High Level Forum on the Capital Markets Union (CMU) noted in its final report[2].

The EU capital market, however, remains fragmented, which could undermine cross-border investment flows and market liquidity necessary to channel funds from financial centres and investors across the globe to the EU and vice-versa. As noted by experts, diverging rules, standards and taxation systems across the 27 Member States impede the creation of an adequate pool of risk capital for early stage and growing innovative businesses implementing sustainable solutions[3]. Moreover, the European economy remains exposed to significant climate risks, as demonstrated by the large proportion of the workforce employed in the carbon-intensive sectors. Against this background and considering the lack of business dynamism (see Figure 1)[4], the EU growth model appears to be adapting insufficiently fast to cater for the future challenges. Regrettably, these developments are happening in the context of increased protectionism, posing additional challenges to market access. The success of the sustainable finance policy agenda in Europe is conditional on and must therefore go hand in hand with the long overdue progress in building a globally connected EU Capital Markets Union.

Growth-Friendly Transition of the Real Economy

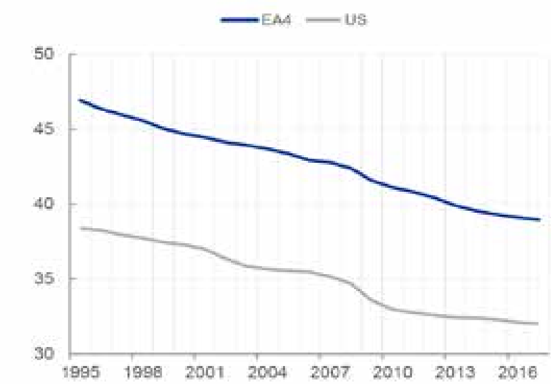
Under the right conditions, the financial system can be a key player in accelerating and amplifying the transition to a sustainable economy. In order to realise its intermediary role in allocating capital according with these objectives, the financial system depends on effective regulatory framework conditions and, as noted by the G30, leadership on the side of the real economy[5]. While the level of regulatory ambition must reflect the urgency to act, it is critical that the transition is well managed and results in a careful balance of companies' transformation while preserving growth and jobs.

An efficient way to incentive transition would be to price carbon at a level that truly internalises the externalities of carbon emissions. Nevertheless, progress remains slow as indicated by the World Bank estimates. Today, only 22% of global greenhouse gas emissions are covered by a carbon price, and of that, less than 5% are currently priced at levels consistent with reaching the temperature objectives of the Paris Agreement. To ensure social acceptance and distributional neutrality, carbon pricing could be accompanied by reduction of other levies and mechanisms such as reimbursements[6].

At present, only a minority of economic activities are operating at zero or close to net zero emissions. Large emitters, often key constituents of mainstream investment portfolios, have a vital role to play in the global emission reduction efforts but are not captured by green finance initiatives. Recognising the importance of the transition pathways and the lack of established market standards in this area, Credit Suisse and the Climate Bonds Initiative issued a white paper proposing a transition framework that goes beyond the EU Taxonomy approach[7].

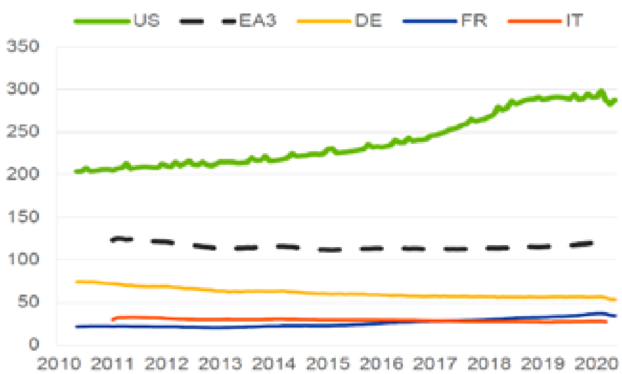
Figure 1: Europe lagging behind in transition to carbon-neutral economy

Employment in carbon-intensive sectors relative to all activities (% of total employees)



Source: Haver and Eurostat. Note: Carbon-intensive sectors are defined on the basis of EU 28 average greenhouse gas emissions during the period 2008-2018 (kg per euro of GVA). The top 50% of sectors, in terms of emissions per GVA (31 NACE 2 sectors in total) are defined as "more carbon-intensive". Latest oberservations 2017.

New business creations (thousands)



Source: INSEE (FR), Destatis (DE, Banca d'Italia (IT), Census Bureau (US). Notes: Number of new businesses outside of agriculture (DE, FR, IT) and number of business applications outside of agriculture (US). 12-M rolling average. FR excludes sole proprietorships.

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The framework provides a common definition of the transition concept and principles for activity and entity level transition, ensuring that investments are aligned with the Paris Agreement's trajectory.

Science-based transition pathways for carbon-intensive industry sectors, closing corporate data gaps as well as investing in climate-specific modelling methodologies must be at the heart of evidence-based policy making for the future. To ensure a smooth transition while maintaining an attractive market environment for investors and businesses alike, the EU must strive to put in place market-friendly sustainable finance regulation, meaningful carbon pricing and ensure a swift progress towards an efficient, open and connected single market for capital.

"Orderly transition to a low-carbon economy is vital for our business and the economic prosperity of our economies. We can only succeed if all stakeholders work together in partnership."

Lukas Gähwiler,
Chairman of the Board, UBS Switzerland AG

The SFC supports and advocates for a strong and ambitious response to climate change and the broader sustainability challenges and its members are committed to supporting governments as they set the pathways for transitions in their respective economies and societies. We also continue working with peers to embed sustainability into our business through the implementation of the UN Principles for Responsible Banking and Principles for Responsible Investment, including by e.g. participation in voluntary pilot testing exercise on implementation of the EU Taxonomy[8] as well as through membership in the Financial Stability Board's (FSB) Task Force on Climate-Related Financial Disclosures (TCFD). We believe that close collaboration of all stakeholders is at the heart of any effective solution for halting climate change.

REAL ECONOMY TRANSITION

A speedy transition to a sustainable economy will more likely occur through direct regulation of primary sectors rather than indirectly through the regulation of financing activities. The EU Commission should further develop science-based transition pathways to guide sustainable investments by measuring the journey towards green. More broadly, to provide incentives for change, externalities must be priced into economic transactions. In this respect, transparent, cross-border and sufficiently high pricing of carbon is a key element needed to support the climate transition. Subsidies to high carbon emitting industries should be phased out and, in the context of the post-pandemic recovery, unconditional public support should be avoided.

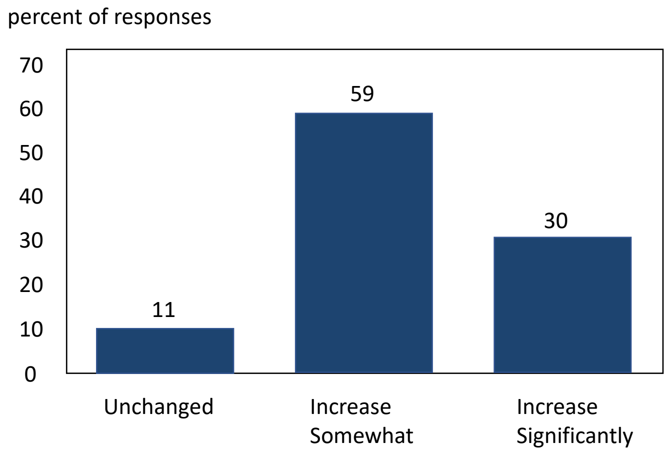
Investors as Key Drivers of Sustainable Finance

Investors want to contribute to tackling global challenges, participate in the investment opportunities arising from anticipation of key trends as well as to protect themselves against transition risks. The new generation of investors (the so-called "millennials") is generally perceived to be more climate-aware than its predecessor, and therefore more likely to reshape the future of investing, thus potentially resulting in a paradigm shift.

Among the largest managers of private and institutional wealth globally, UBS and Credit Suisse accompany and advise investors, for example by enhancing the systematic integration of ESG considerations into products and services, advancing innovative product solutions and continuously growing the offering of sustainable investment products to their clients. UBS Asset Management has recently rolled out its Climate Aware Approach across asset classes, launching a new suite of investment strategies that includes equity and fixed income, and both active and passive approaches which are the building blocks of most portfolios[9]. In January 2021, UBS published a white paper[10] identifying ten sustainable finance trends, i.e. investor engagement, impact investing, electric transport, net zero, big oil, diversity, plant-based meats, climate stress testing, sustainable data and transparency revolution. Credit Suisse's Group-wide Climate Risk Strategy was introduced in 2019, in order to support its clients during the transformation process towards a low carbon world. Within the last 14 months, Credit Suisse has brought a various range of products to the market tracking the UN Sustainable Development Goals. Credit Suisse and UBS are both highly committed to accelerate and embed sustainability efforts throughout all client segments by infusing ESG principles across its global research, advisory and investment units.

Increasing investor appetite has been among the most important drivers of the continued evolution of mainstream investing towards sustainable strategies. In the 2020 Global Climate Finance Survey[11], 90% of the participating financial firms expected client demand for sustainable instruments to increase over the next twelve months (see Figure 2).

Figure 2: Over the next twelve months, how do you expect your clients' demand for sustainable instruments to change?



Source: IIF/EBF Global Climate Finance Survey

While both retail and institutional investors have been instrumental in pushing ESG investing, institutional investors are leading the trend. Already before the pandemic, most European asset owners envisaged that environmental factors will overtake financial factors in terms of materiality for their investments within the next five years.

The large inflows into sustainably managed funds and broad outperformance of ESG assets observed in 2020, showcased the synergy between sustainability and performance and disproved the notion of a return trade-off. The European Securities and Markets Authority (ESMA) Trends, Risks, and Vulnerabilities Report illustrated that in the first half of 2020 the "EU-domiciled ESG equity funds attracted net inflows of EUR 14 bn (2% of AuM), while other EU equity funds experienced net outflows of EUR 77 bn"[12].

Addressing Market Failures: Data Gaps

Rigid and overly prescriptive policies are likely not best suited for incentivising the acceleration of sustainable finance. Instead, regulatory resources should be primarily directed at correcting market imperfections that impede the development and provision of new products and services by financial market participants. Such approach, recognising the existing market-led efforts, has been adopted in Switzerland, where the penetration of financial instruments managed in accordance with ESG considerations is already about twice as high as the global average[13]. In 2020, the Swiss government reaffirmed its views on the primacy of market-based solutions, the subsidiarity of government action and the role of transparency and a long-term focus[14].

Integration of ESG considerations in investment processes and products relies on timely and accurate data. In the absence of information indicating which companies will face difficulties in the changing environment, financial markets cannot effectively price climate-related risks and opportunities.

The current corporate ESG disclosures landscape, characterised by a multitude of voluntary reporting standards, remains fragmented, inconsistent and raises data comparability challenges. Inconsistencies in corporate disclosures also lead to increased reliance on proxies, thereby translating the problem also into the area of ESG data provision and ratings. According to researchers, ESG ratings across five major ESG rating providers were only 60% correlated, compared with 99% for credit ratings from the three largest credit-rating agencies[15]. ESG ratings can confound investors unless they take the time to test rating firms' underlying assumptions and the subjective overlays that lead to a specific rating decision.

The quality of data varies greatly across jurisdictions while the lack of data is reported as a key barrier in developing ESG products. Despite some improvements, data gaps persist and do not only hinder the credibility and scaling up of sustainable finance, but also the development of appropriate risk assessment and monitoring frameworks. Rationalisation of the disclosure framework will be necessary also to unlock the potential of new technological tools such as big data and artificial intelligence, which can accelerate improvements in the accuracy of the reported data. In order to be meaningful and effective for investors, disclosure standards should take a forward-looking perspective with respect to risks and opportunities, rather than a backward-looking view, e.g. footprinting of past emissions. For instance, the TCFD includes metrics for Implied Temperatures Rise (ITR) in its consultation on forward-looking financial sector metrics. ITR metrics aim to provide a forward-looking view of carbon exposure that can be applied to a wide range of industries, companies and asset classes.

For the EU sustainable finance framework to be an efficient and successful tool, the mandates assigned to the financial sector (e.g. disclosures of portfolio alignment with the Taxonomy or principal adverse impacts on ESG) and on non-financial corporates will have to be coordinated and aligned. As acknowledged by the ECB, the EU Taxonomy Regulation can only become fully operational if more and better non-financial information is available on the corporates' side[16]. The European Commission has requested the European Financial Reporting Advisory Group (EFRAG) to start preparatory work for the development of non-financial reporting standards, should this be agreed by the co-legislators under the review of the Non-Financial Reporting Directive[17]. Moreover, a potential regulatory regime for ESG service providers might be considered under the upcoming Renewed Sustainable Finance Strategy.

While these efforts are very much welcomed, an internationally aligned approach bringing together a range of companies, investors, sustainability-setting bodies, regulators, and ESG ratings agencies will eventually be needed. Proactive engagement at global level is necessary to avoid regulatory fragmentation, ensure level playing field for companies and to provide international comparability for investors. Encouraging initiatives are already underway, most notably the development of sustainability Generally Accepted Accounting Principles (GAAP) standards by the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI) or a launch of a global reporting framework for ESG by the World Economic Forum International Business Council (IBC), with the support of global accounting firms. In January 2021, both Credit Suisse and UBS have committed to the core Stakeholder Capitalism Metrics released by IBC among 59 other companies from various industries. This initiative is a great example to show the willingness of the business community to further catalyse cooperation and alignment among existing standards and encourage progress on the development of a systemic, globally accepted set of common standards for reporting on sustainability performance. These efforts can support the vision articulated by the standard setters themselves. The aspirations announced by the International Organization of Securities Commissions' (IOSCO) Task Force on Sustainable Finance[18] to identify and develop material disclosure categories as well as the International Financial Reporting Standards (IFRS) consultation suggesting the creation of a Sustainability Standards Board[19] constitute important first steps towards the international standardisation of disclosures that must be supported.

CLOSING THE DATA GAPS

As an immediate step in the context of the review of the EU Non-Financial Reporting Directive, consistency must be established between the Taxonomy Regulation and the corporate disclosure requirements. With a view to increase global transparency, to reduce due diligence costs for global investors and administrative costs for multinational corporates, the ultimate objective should be the establishment of a common global ESG reporting standard that is based as much as possible on existing reporting standards. It will be important for Europe to ensure the flexibility to align and recalibrate its rules with international standards as they may develop.

Global Alignment

The global sustainable finance regulatory landscape is fragmented into a patchwork of measures with various levels of ambition or aimed at different areas of financial markets. Divergent regulatory approaches complicate management of global investments and elevate the risk of insufficient financing for the global transition. Moreover, regional initiatives are unlikely to sufficiently respond to global phenomena such as climate change. Furthermore, with the increasing number of new initiatives, it is also difficult for the industry to navigate among their different goals and decide where resources should be dedicated and prioritised.

Climate risk stress tests, scenario analysis and ESG disclosures are all areas that would benefit greatly from more international alignment. In particular, the efforts to develop common disclosure standards need to be compatible with the ongoing work on taxonomies to avoid market barriers as taxonomies present the basis for effective disclosure metrics. Global cooperation will also be indispensable to establish linkages among different jurisdictions' carbon pricing initiatives and to reducing the current fragmentation of the carbon markets.

With the 2018 EU Sustainable Finance Action Plan, there is no doubt that measures implemented in the EU have immediate impact and influence jurisdictions outside the bloc. While the establishment of the IPSF as well as the Network for Greening the Financial System (NGFS) are very welcomed, it is important to note that neither of them has a legal personality or a standard setting mandate. Their work will nevertheless be instrumental in preparing the ground for international standard setters. The European Commission could leverage the technical knowledge and political commitment built up within IPSF and at G20 level and initiate the establishment of a sustainable finance agenda similarly to the post-2008 crisis financial regulatory reform agenda.

In its effort to lead the sustainable finance agenda globally and given the widely recognised need for sustainability considerations in the post COVID-19 recovery, the European Commission must consider and avoid as much as possible any fragmentation effects when elaborating the Renewed Strategy on Sustainable Finance and continue pressing for alignment of the emerging sustainable finance frameworks globally.

GLOBAL COORDINATION

Capital markets are global in their nature. Similarly, climate change is a global phenomenon. Both therefore require an internationally coherent approach. To successfully contribute to the efforts to complete the CMU and to reach the EU sustainability objectives, global finance demands aligned regulatory frameworks underpinned by international standards. The overall sustainable finance agenda should therefore be coordinated via the G20/FSB with a view to establishing common principle-based standards.

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