

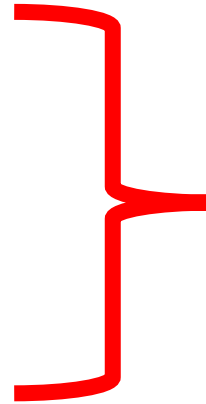
'The EU's Sustainable Finance Initiative: Limits to Market-Driven Sustainability'

Professor Jay Cullen, University of Oslo & University of York



The main planks of the SFI

- Taxonomy
- Disclosure Regulation (plus non-Financial Reporting Directive)
- Benchmarks Regulation
- Green Deal
- Corporate Governance reform



Market-led



Fiscal & Regulatory

Sustainable finance

The EU is examining how to make sustainability considerations an integral part of its financial policy in order to support the European Green Deal

Overview of sustainable finance

A Commission workstream that supports the European Green Deal aim of channelling private investment towards the transition to a climate-neutral economy.

Corporate disclosure of climate-related information

Guidance for companies on how to report on the impacts of their business on the climate and on the impacts of climate change on their business.

International platform on sustainable finance

Forum for dialogue between policymakers, with the aim of increasing the amount of private capital being invested in environmentally sustainable investments

EU taxonomy for sustainable activities

What the EU is doing to create an EU-wide classification system for sustainable activities.

EU climate benchmarks and benchmarks' ESG disclosures

Make benchmark methodologies more transparent when it comes to ESG factors & put forward standards for the methodology of low-carbon benchmarks in the EU.

EU Green Bond Standard

How an EU-wide standard could encourage market participants to issue & invest in EU green bonds and improve the effectiveness & credibility of the market.

Sustainability-related disclosure in the financial services sector

What the obligations are for manufacturers of financial products and financial advisers towards end-investors.

Taxonomy

1. Member States or the EU when adopting measures or setting requirements on market actors in respect to **financial products or corporate bonds** that are marketed as environmentally sustainable.

2. **Financial market participants** offering financial products as environmentally sustainable investments or as investments having similar characteristics.

‘DNSH’ principle

- While the taxonomies for climate mitigation and climate adaptation have been developed, four more taxonomies will be published by the end of the year:
 - (i) sustainable use and protection of water and marine resources;
 - (ii) transition to a circular economy, waste prevention and recycling;
 - (iii) pollution prevention and control; and
 - (iv) protection of biodiversity and ecosystems.
- **BUT: see “natural gas”**

Non-Financial Reporting Directive & Disclosure Regulation

- **NFRD**
 - **Materiality**
 - Companies to disclose information on environmental, social and employee matters, respect for human rights, and bribery and corruption, to the extent that such information is necessary for an understanding of the company's development, performance, position and impact of its activities.
 - The materiality perspective of the Non-Financial Reporting Directive covers both financial materiality and environmental and social materiality
- **Disclosure Regulation**
 - **Requires disclosure of:**

Evaluation – Pros (I)

- Taxonomy and green bond standards are welcome developments – may spur much greater volumes of green bond investment, which will be important in funding transition away from fossil fuels
- Standardisation of information is welcome
- In principle, new regulations focus on issues beyond climate change
- Provides roadmap for transition to low carbon future of finance

- Evaluation – Cons **Basic Level**

- Benchmarks regulation likely to be of limited impact
- Places too much emphasis on information & transparency
- Places too much emphasis on private finance
- Lacks requisite ambition
- *“Meeting Sustainable Development Goals (SDGs), the Paris Agreement commitments and other environmental goals will require substantial investments **far beyond what the public sector can muster**. Mobilising and re-directing private capital is necessary for meeting EU’s climate, environmental and sustainability commitments.”*
- 175bn EURO per year needed. EU economy is approx. 15 trillion EURO. So barely 1% of economy.

Conceptual Problems – Mark Carney, ‘Better Market Information Can Help Combat Climate Change’
(*Financial Times*, 28 June 2017)

Carney has argued that:

‘[f]inancial markets have the potential to improve our prospects for tackling climate change, **but only if we make climate risks and opportunities more transparent...**

Along with analysis of wider market conditions, investors need accurate data. The more incomplete or opaque the data and analysis, the more inefficient are markets. **Yet the climate-related risks and opportunities businesses face are currently shrouded in secrecy.** Having information on such risks would allow investors to back their convictions with their capital, whether they are climate optimists or pessimists, evangelicals or sceptics. It would also permit corporates not only to meet investor demand for information, but also to position their businesses to win, rather than be left behind in, the transition to a low-carbon economy ... by acting in their own interests, leading companies, banks and investors from across the G20 are helping society address one of the gravest challenges we face. The more transparent and effective we make markets, the more we will all benefit.”

Cullen (2018)

Statements such as [Carney's] bear all the hallmarks of similar pronouncements on the efficiency and effectiveness of market-determined pricing, according the market—even in the face of a challenge as great as climate change—with the role as primary arbiter of the level and character of adjustments to industrial strategies and investor portfolio preferences. In Carney's language, the relevant mix of investors between 'optimists and pessimists, evangelicals or sceptics' will determine the allocation(s) of investment capital to particular projects and their convictions will be tested by future events.

Yet...**characterising the information gaps in market understanding of the financial risks of climate change by using such terms as 'secrecy' or 'win[ning]' is highly dubious.** For example, it is trite to observe that the risks from climate change to economic and financial systems are not hidden; this implies that someone, somewhere has the requisite information to address the problem and, by implication that the problem contemplated is soluble. **In reality, there is no agreement even on the likely shape of the damage function in relation to climate change, still less any consensus on what this will mean for financial markets.** Moreover, there are few objective bases upon which to be 'optimistic' or 'pessimistic' regarding the potential consequences of climate change, particularly in extreme outcomes. These factors have important consequences for the regulation of financial markets, particularly in relation to banks which finance activities that contribute to climate change.

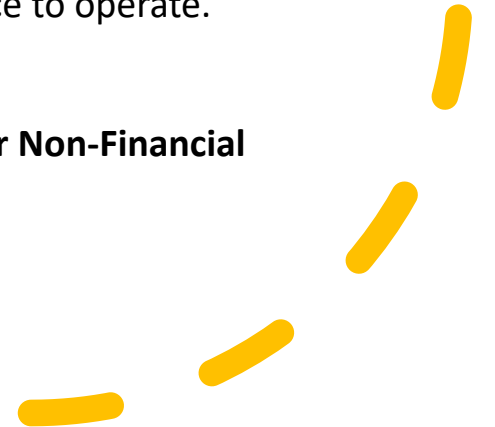
Disclosure benefits....

Benefits for reporting companies

Better disclosure of climate-related information can have benefits for the reporting company itself, such as:

- increased awareness and understanding of climate-related risks and opportunities within the company, better risk management, and more informed decision-making and strategic planning;
- a more diverse investor base and a potentially lower cost of capital, resulting for example from inclusion in actively managed investment portfolios and in sustainability-focused indices, and from improved credit ratings for bond issuance and better credit worthiness assessments for bank loans;
- more constructive dialogue with stakeholders, in particular investors and shareholders;
- better corporate reputation and maintenance of social licence to operate.

Although reporting of climate-related risks is mandatory under Non-Financial Reporting, these guidelines are non-binding.



Do markets care?

Bond Data

ISIN	US30231GBA94
Name	EXXON MOBIL 19/22
Country	USA
Issueance	
Issuer	Exxon Mobil Corp.
Issue Volume	750,000,000
Currency	USD
Issue Price	100.00
Issue Date	8/16/2019
Coupon	
Coupon	0.486%
Denomination	1000
Quotation Type	
Payment Type	regular interest
Special Coupon Type	variable coupon
Maturity Date	8/16/2022
Coupon Payment Date	8/18/2021
Payment Frequency	
No. of Payments per Year	4.0
Coupon Start Date	11/18/2019
Final Coupon Date	8/15/2022
Floater?	No

Bond Data

ISIN	XS1327914062
Name	TOTALENERGIES 15/22 CV
Country	France
Issueance	
Issuer	TotalEnergies SE
Issue Volume	1,200,000,000
Currency	USD
Issue Price	100.00
Issue Date	12/2/2015
Coupon	
Coupon	0.500%
Denomination	200000
Quotation Type	
Payment Type	regular interest
Special Coupon Type	
Maturity Date	12/2/2022
Coupon Payment Date	12/2/2021
Payment Frequency	
No. of Payments per Year	2.0
Coupon Start Date	6/2/2016
Final Coupon Date	12/1/2022
Floater?	No

Bond Data

ISIN	US166756AK27
Name	CHEVRON USA 20/23 FLR
Country	USA
Issueance	
Issuer	Chevron USA Inc.
Issue Volume	500,000,000
Currency	USD
Issue Price	100.00
Issue Date	8/12/2020
Coupon	
Coupon	0.360%
Denomination	1000
Quotation Type	
Payment Type	regular interest
Special Coupon Type	variable coupon
Maturity Date	8/11/2023
Coupon Payment Date	8/11/2021
Payment Frequency	
No. of Payments per Year	4.0
Coupon Start Date	11/11/2020
Final Coupon Date	8/10/2023
Floater?	No

Sustainable corporate governance

- The most preferred option of overall respondents answering was the most ambitious option (331 respondents, 48.1%), namely a minimum process and definitions approach complemented with further requirements in particular for environmental issues (incl. alignment with the goals of international treaties and conventions).
- Respondents that preferred a minimum process and definitions approach with or without further requirements, indicated the following areas to be covered: human rights (94.3%) and followed by climate change mitigation (85.6%), natural capital, land degradation, ecosystem degradation, etc. (83%) and interests of local communities, indigenous peoples' rights, and rights of vulnerable groups (83.2%).

SMART Project 2020 Report - Recommendation

- Commercial loans, commercial credit facilities (other than overdrafts), syndicated loans, or project finance agreements are subject to a **mandatory due diligence assessment** before they are agreed;
- In conducting this assessment, financial institutions should use the OECD bank-specific guidelines, while encompassing all relevant environmental, social and governance issues;
- The relevant financial institution's credit committee must make a recommendation to the board of directors based upon this;
- There would be a presumption that these requirements are applicable to all such loans, credit facilities or project finance agreement(s);
- However, banks and financial institutions may rebut this presumption for certain categories of project; namely, those projects deemed as projects covered by the existing EU Taxonomy.



Haldane – The Long Short (2011)

	10%	1%	0.1%
Rational ($x=1$)	29	57	85
Mild myopia ($x=0.95$)	18	35	52
Strong myopia ($x=0.90$)	13	25	37

Notes: The number in the table refers to the first year that a \$10 cash-flow falls below 10%, 1% and 0.1% of its actual value in present value terms. The rational discount uses an average risk free rate from our cross sectional data sample (1.085).

To put the point more starkly, Table 7 asks at what point in the future the residual value of a future cash-flow hits a level of 10%, 1% and 0.1% of its face value, under rational and myopic discounting. Under rational discounting, cash-flows even 50 years ahead retain more than 1% of their face value. Under strong myopic discounting, this residual threshold is reached after 25 years. Virtually zero weight – less than 1000th of the face value of the cash-flow – is placed on projects with income streams much beyond 35 years. The long is dramatically shortened.

This is a market failure. It would tend to result in investment being too low and in long-duration projects suffering disproportionately. This might include projects with high build or sunk costs, including infrastructure and high-tech investments. These projects are often felt to yield the highest long-term (private and social) returns and hence offer the biggest boost to future growth. That makes short-termism a public policy issue.

(a) Transparency

(b) Governance

(c) Contracts

(d) Taxation /
Subsidies

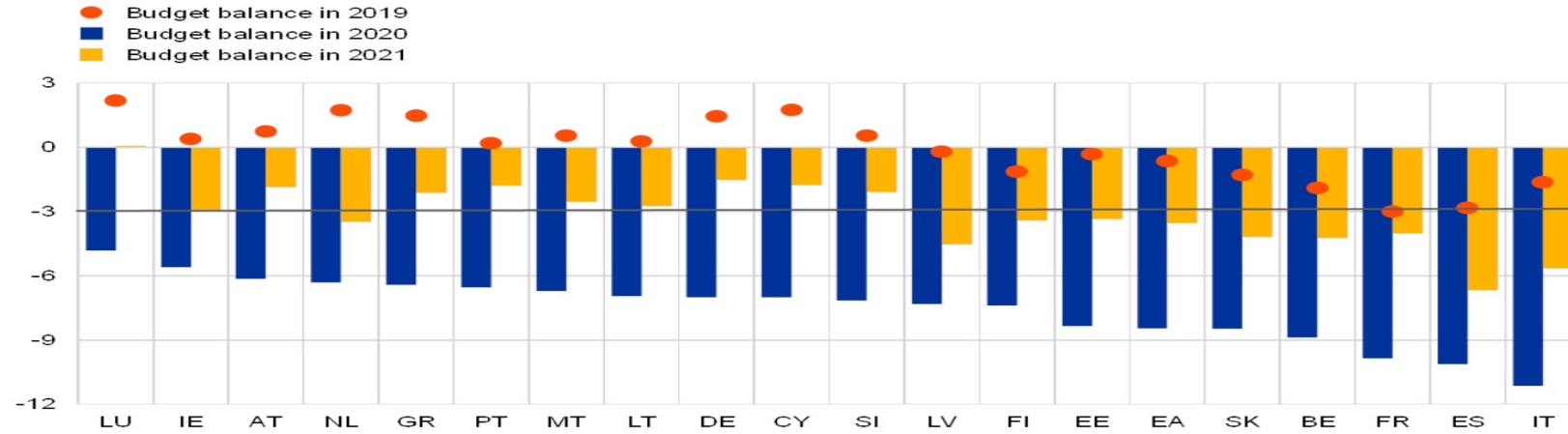
Evaluation – Cons - Higher Level

- Protects finance from the environment, rather than the environment from finance
- Ignores climate change as market failure
- Creates new subset of financial products/instruments offering higher than normal yields
- Will likely generate pressure for more asset mining to generate returns
- Green finance may become new mortgage finance, with disproportionate consequences for global south

Chart A

General government budget balances, 2019-2021

(percentages of GDP)

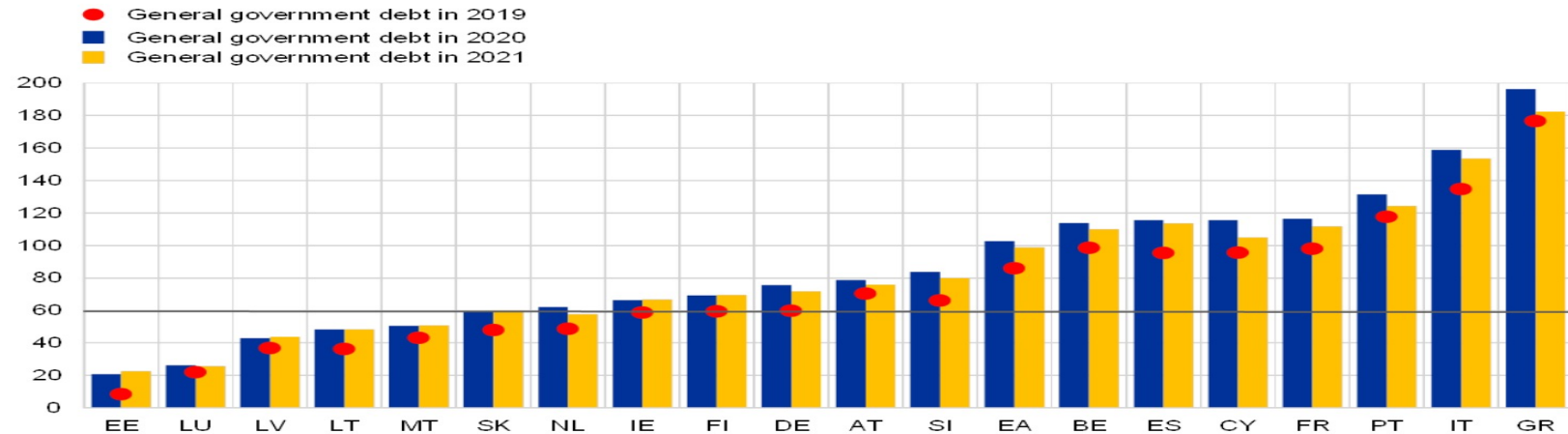


Sources: European Commission (AMECO database) and ECB calculations.

Chart B

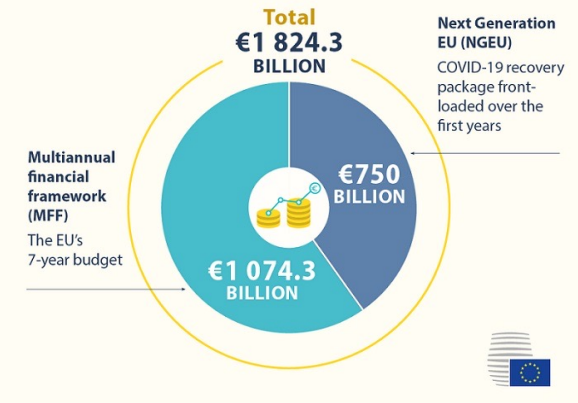
General government gross debt, 2019-2021

(percentages of GDP)



Sources: European Commission (AMECO database) and ECB calculations.

EU budget 2021-2027 and recovery plan



EU Green Deal

- €503bn comes from the existing EU budget, unleashing a further €114bn from national governments
- The next €279bn would come mostly from the private sector: companies encouraged to make risky green investments by loan guarantees from the European Investment Bank, the EU lender.
- On top of this Brussels has promised a €100bn “just transition” mechanism to help retrain workers who lose jobs in shuttered coal mines or steel factories.



€1tn is only one third of what is needed, if the EU follows through with the commission’s plan to reduce European greenhouse gas emissions by up to 55% by 2030 (Bruegel)

Biden plan: Public, not private, finance

Infrastructure investment

+ Add to myFT

Investors lament being frozen out of Biden infrastructure plan

Asset managers and pension funds hoped public-private partnerships would give opportunities



Private capital vehicles dedicated to infrastructure have amassed \$655bn in assets, enough to pay for trillions of dollars of investment once debt financing is added © Getty Images

Unlike the federal government, which pays a lower interest rate on its debt than almost any other borrower, private sector infrastructure operators must earn commercial rates of return, a cost that ultimately lands on the users of essential services.

“If the Biden administration wants the cheapest financing costs they will fund projects federally,” Fink said.

But some executives argue private-sector involvement can impose commercial discipline and generate savings elsewhere.

Others hope that Biden can be persuaded to sell off assets that are currently in public ownership, allowing investors to earn a return on existing infrastructure while leaving risky construction work to the public sector.

“The world’s changed a lot in the last 80 years,” said a top executive at a firm that has invested billions of dollars in energy and transport assets, expressing a widely held frustration at Biden’s slowness to embrace private-sector participation in his public investment programme.

“An entire infrastructure industry’s been born. And there are ways for the administration to partner with private partners, to accelerate, multiply and increase the efficiency of what they’re doing.”

Dasgupta Review (2021)

“While financial actors have a key role to play in shifting from Impact Inequality to Equality – through greater channelling of financial flows towards natural assets and their sustainable use – it should be stressed that their role is ultimately bound by broader government and regulatory policies to correct for institutional failures. [There has been a] failure of governments to internalise externalities fully, through fiscal measures, standards, regulations and market mechanisms. This failure means that financial markets cannot incorporate these costs into pricing, and therefore into credit allocation and lending decisions.”

Figure 1. Relative change in main global economic and environmental indicators from 1970 to 2018

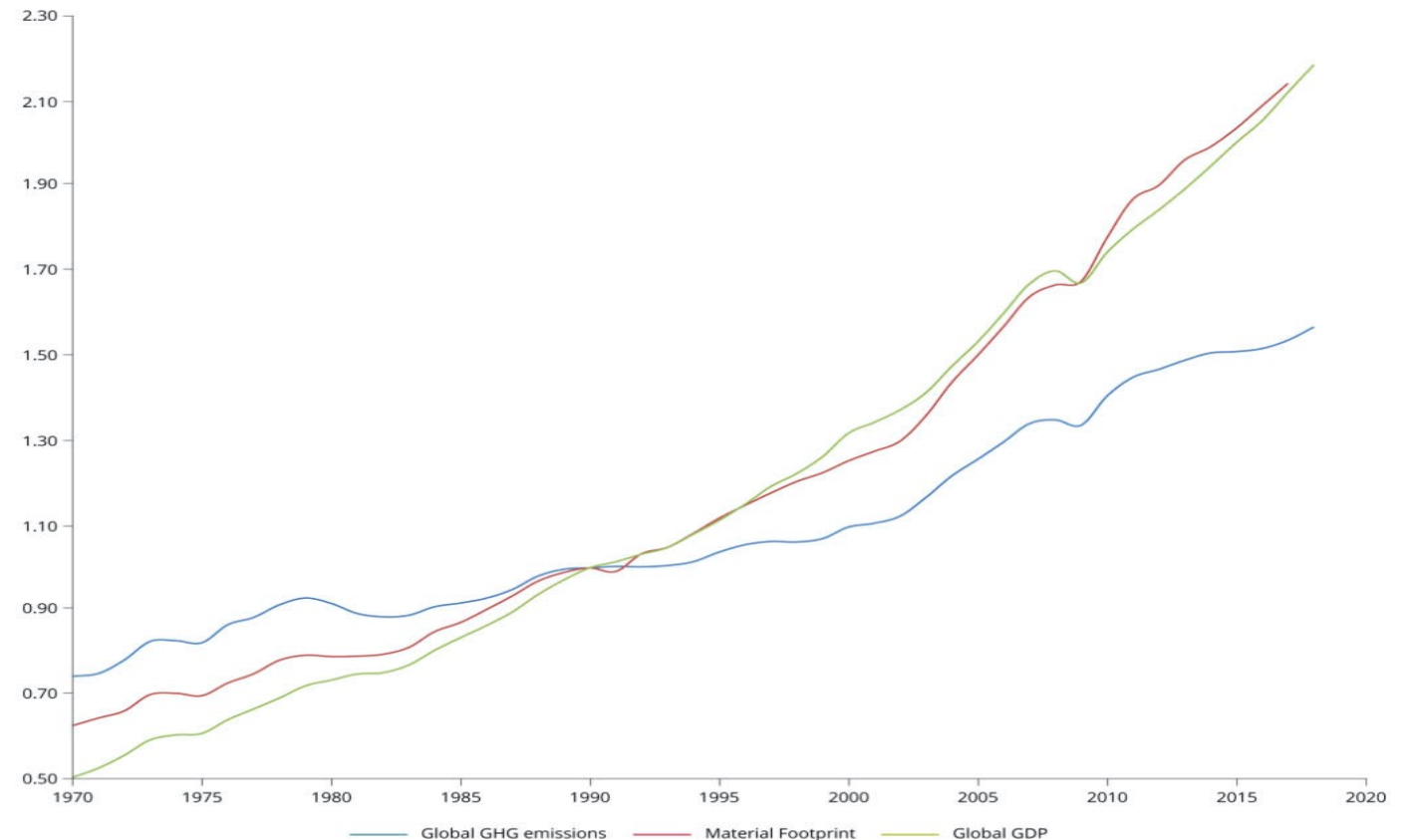
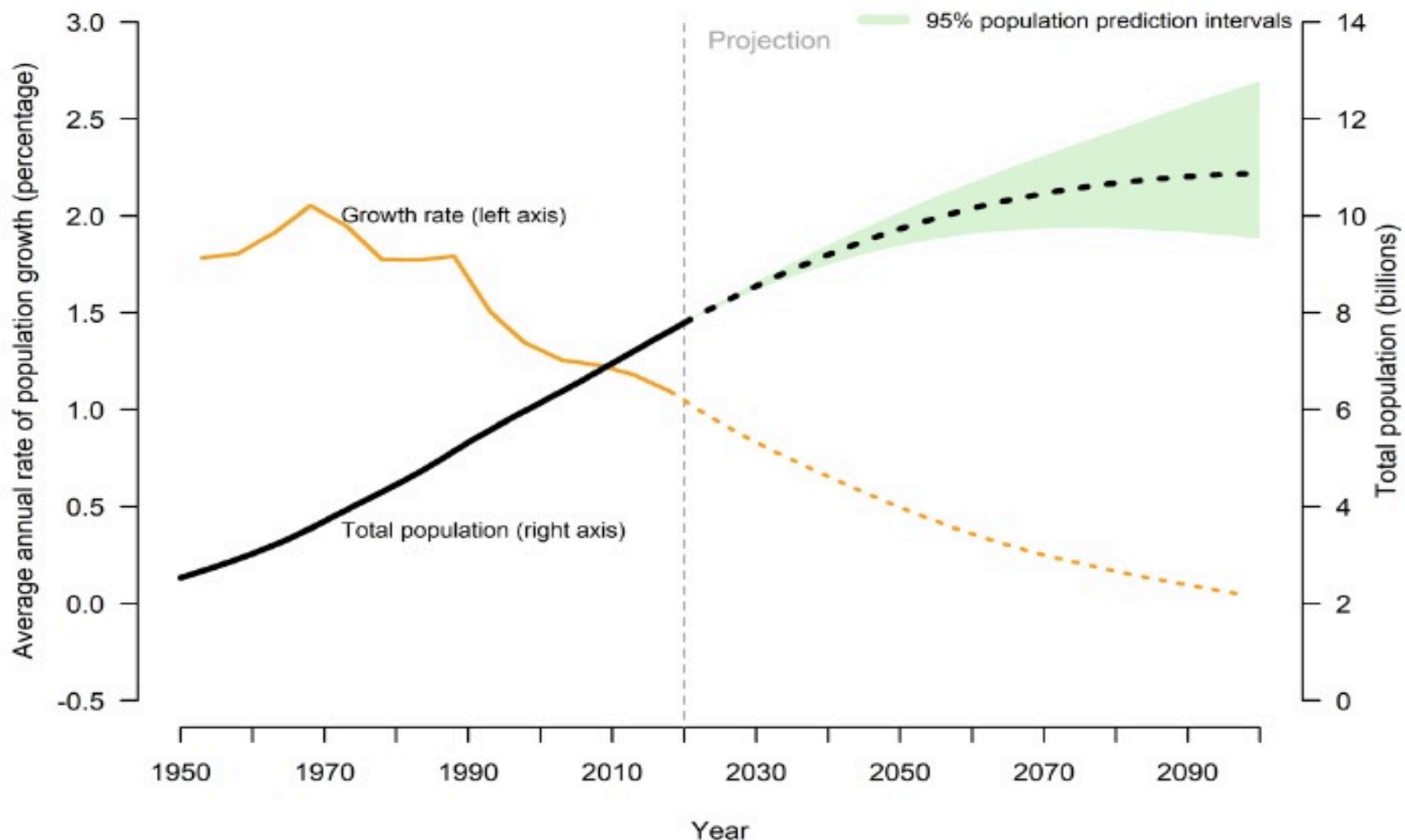


Figure 1. Population size and annual growth rate for the world: estimates, 1950-2020, and medium-variant projection with 95 per cent prediction intervals, 2020-2100

Population growth continues at the global level, but the rate of increase is slowing, and the world's population could cease to grow around the end of the century



Data source: United Nations, Department of Economic and Social Affairs, Population Division (2019). *World Population Prospects 2019*.