Sustainable Finance: Turning Regulatory Obligations into Commercial Success

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Financial institutions are currently working on implementing various new European sustainability regulations

As always, such implementation is a complex and time-consuming exercise, with hard regulatory deadlines. But the good news is that regulatory projects, if properly designed, can also contribute to the realization of strategic goals and commercial successes. This article gives some suggestions on how this can be done.

Voluntary sustainability frameworks as basis

Over the last three decades a vast amount of voluntary sustainability frameworks for financial institutions have been launched. Examples are Global Compact (GC), Principles for Responsible Investment (PRI), Climate Disclosure Project (CDP), Taskforce on Climate related Financial Disclosures (TCFD) and many others.

Judging by the extent to which they are still used today, one can safely say that these voluntary frameworks have been successful in embedding an environmental, social and governance basis in the financial sector.

At the same time, however, it is also clear that these frameworks are still very diverse and show little harmonization. Each framework is for example still using its own definitions and methods. Partly for this reason, a sustainable investment can still be defined in many different ways. For some, a sustainable investment means 'not investing in fossil fuels, nuclear energy or weapons'. Others still claim that sustainable investment is about 'engagement', meaning dialogues with lagging companies to move them towards more sustainability. And a last group of investors defines sustainable investments as 'investments that contribute to the Sustainable Development Goals (SDG).

Due to this lack of agreement on definitions and methods, sustainability remains a difficult concept for many financial market parties. Simple questions, for example about the size of the market for sustainable investments therefore have multiple answers. And discussions about greenwashing - is the product indeed as sustainable as it claims to be - pop up again and again.

The above lack of harmonization, together with rapidly increasing concerns about the changing climate, have been two important arguments for the European Commission to formulate an Action Plan for sustainable finance in 2018.

European regulation to better anchor the basis

The European Commission Action Plan, called ‘Financing Sustainable Growth’, aimed to:

1. Reorient capital flows towards sustainable investment to achieve sustainable and inclusive growth,
2. Manage financial risks stemming from climate change, resource depletion, environmental degradation, and social issues, and
3. Foster transparency and long-termism in financial and economic activity.

Since 2018, many new European regulations for financial institutions have seen the light or will soon be launched.

‘The impact of this sustainability related legislative package is going to be far reaching’

The most central and fundamental piece of new regulation to date is the EU Taxonomy, as it will lead to a single harmonized European definition of ‘sustainability’. Other recent examples of new EU sustainability regulations are the Sustainable Finance Disclosure Regulation (SFDR), Pilllar 3 ESG and the new EBA Guidelines on Loan Origination and Monitoring (EBA GLOM). And let’s not forget MiFID II (inclusion of sustainability in the suitability test and product governance), the changes in AIMF/UCITS regulations and the announcement of the Corporate Social Responsibility Directive (CSRD) that will replace and expand the scope of the Non-Financial Reporting Directive (NFRD).

The impact of this sustainability related legislative package is going to be far reaching and not isolated to a single department or domain. Just imagine your own car. We’re not talking about simply replacing the left taillight, one of the tyres, or the centerpiece of the pop pipe. No, this is about adjusting important engine components and a large part of the car interior. So please, be prepared. It is going to take some time.

Implementing new regulations is time-consuming

In the financial sector the new sustainability regulations have risen to the top of the agenda quickly, as complying with regulations is important to keep the license to operate. And because a lot of work needs to be done.

What kind of work are we talking about?

First, the new sustainability regulations require interpretation, not least because they contain new definitions and formulations, that have not been used before. And interpretation is anything but easy; see the text box for a recent example.

On SFDR and interpretation

SFDR (Sustainable Finance Disclosure Regulation) requires financial service providers to categorize their investment products into three groups: financial products that promote ecological or social characteristics (article 8), financial products with sustainable investment as their objective (article 9) and funds that do not have sustainability characteristics (article 6).

After financial service providers had published their first categorizations in March 2021, the Dutch Authority for the Financial Markets (AFM) did a review and concluded in September 2021 that there was room for improvement. For example, AFM found that many funds that were classified as Article 9, had much broader objectives than the narrow sustainable objective intended by SFDR. The discussion about SFDR is clearly not over yet.

After initial interpretation of new legislation, financial institutions need to consider at least six other perspectives:

1. **ESG data:** As most sustainability regulations will require to use new ESG data, a gap analysis is needed to determine which data is already available and which data is still missing. Missing ESG data must then be supplemented. Think for example on the hazardous waste ratio per investee, to be able to deliver the so-called Principle Adverse Impact (PAI) statement under SFDR. Sometimes these data can be purchased externally from data vendors, for example in case of listed investees/companies, but for non-listed SME's other approaches need to be developed e.g. using investee questionnaires.

2. **Methods:** Collecting or creating new ESG data will often result in changing calculation methods as well, or - in some cases - in completely new methods being developed. An example is the development of the new PCAF (Partnership for Carbon Accounting Financials) method, to calculate carbon emissions per mortgage, corporate loan or other type of assets, and to be reported as part of Pillar 3 ESG.

3. **Policies:** Changing data and methodologies often also trigger changes in internal policies. Think of changes in credit, market, and operational risk policies to better embed physical and transitional climate risks.

4. **Governance:** To bring the existing organization in line with the new regulations, it may prove necessary to adapt the existing governance as well. Examples are new committees, changing product approval processes or the introduction of new functions and roles.

5. **IT changes:** In many cases, new regulations will also lead to changes in IT systems. Consider, for example, IT changes to ensure that new ESG data can be reported to all relevant stakeholders.

6. **Disclosures / reports:** Finally, many regulations require existing disclosures to be adapted or new ones to be created. Prospectuses, websites, and annual reports are just some examples.

Given the realization of these six perspectives requires the involvement of many different banking disciplines – e.g. Legal, Compliance, Risk Management, Modelling, IT, Product Management, Procurement and External Communication – a project structure is a logical approach when implementing new regulations.

Usually the associated project goal is defined as implementing all legal requirements as efficiently as possible and within given timelines. If that goal is met, the box 'successfully finalized' can be ticked.

How a different approach can lead to more results

Now imagine the fictional Broad Bank. Instead of focusing solely on the timely implementation of the regulation, Broad Bank chooses a broader view. 'Of course we will comply with the legislation in time, but that is only the first step', says the project leader. 'After all, in addition to regulators, we have more stakeholders to serve. So let's use this regulatory momentum to create additional value for all stakeholders: clients, shareholders, employees, and society at large. Because isn't that what our strategy is about?'

'Let's use this regulatory momentum to create additional value for all stakeholders'

Then, first the objective of the regulatory project is expanded. Apart from implementing all legal requirements as efficiently as possible and within given timelines, the project team is also expected to identify possible efficiency improvements and investigate whether the project can contribute to a better client experience. To assure that these additional project goals are also followed up, the project team is extended with specialized change managers and representatives from the business.

The latter know – e.g. from recent client surveys – that client satisfaction would significantly increase if client reports would become more personalized and contain more relevant ESG information. And because these employees are part of the regulatory project now, they will easily find out that much of the information needed for such personalized reports will soon become available.

To get a better picture of the IT changes that are necessary to use the new data for personalized client reports, an IT architecture analysis is done. This analysis shows that the number of necessary modifications is relatively small. But it also reveals a list of other improvement items, not necessary but desirable from an efficiency point of view. Examples include manual and therefore error-prone operations, calculation modules that are not integrated into systems (e.g. in Excel) and incomplete documentation. These are also tackled, because 'now that we are thoroughly overhauling the engine anyway, we can do this in one go'.

In the end the result of this project is that Broad Bank meets all legal requirements on time, has created a solid plan to better serve its clients and can add various efficiency projects to its backlog that will ultimately contribute to lower costs. A few months later, a selection of clients are already receiving personalized reports.

Conclusion

Sustainable finance in the financial sector is currently heavily focused on implementing new laws and regulations. Everything is being done to meet the deadlines.

But those who know the long history of sustainable finance in the financial sector know that it is about much more than 'just' implementing laws. Sustainability is, almost by definition, about what is beyond the law. It is about value creation all along the value chain.

In this article, we have tried to bring renewed attention to this broader view of sustainability. We have shown that implementing new regulation does not have to stop a bank from simultaneously working on value creation for all stakeholders. In fact, in many cases regulatory changes offer an excellent opportunity to do so. So let's take that opportunity, together.

What can Synechron offer?

Synechron's Sustainable Finance & ESG Vision

Synechron enables FIs to tackle SF/ESG challenge and to accelerate the much-needed sustainability transition

Sustainable Finance Regulatory Compliance & Change

- SFDR, EU Taxonomy, ECB Pillar 3 ESG Guide, MiFID II ESG, Basel Pillar III ESG...
- Impact assessment, gap analysis & roadmap
- Overall design & implementation (policies, processes, governance, IT...)

ESG Data Management & Solutions

- Setup & rollout of ESG related data landscape
- Embedding ESG from strategy to implementation
- Cutting edge solutions i.e. ESG Booster & ESG Navigator

Climate & Other ESG risks

- Risk measurement, modelling & stress testing
- Monitoring & reporting
- Program & change management

Training & knowledge sharing

Getting started with ESG

Sustainable finance regulations

Leveraging digital solutions & innovation for accelerating your sustainability transition

Sustainability Partnership

Future-Fit Business

Green RWA

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and more...

Want further, in-depth information and insight about our capabilities and vision on Sustainable Finance?

Connect with us and let's talk!

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