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Sustainable Finance

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As per the European Commission, the achievement of the Paris agreement's climate and energy targets for 2030 require additional yearly investments of EUR 180 billion. As the financial sector plays a key role in facilitating capital flows, the EU is working on integrating sustainability considerations into financial policy frameworks (referred to as 'sustainable finance'). In the context of the Paris agreement and the UN Sustainable Development Goals, it will not belong before financial service providers feel the impact of sustainable finance.

In this article, the legislative and non-legislative proposals of the Commission are considered, alongside the potential impact of these proposals on several financial service providers. The key takeaways are listed below:

- The proposals will have a considerable future impact on the business processes of manufacturers of financial products (like sustainable investment funds, and providers of investment services, such as asset and wealth managers)
- In addition to the impact on processes, characteristics of the financial instruments included in portfolios also can be impacted significantly if the shift towards sustainable investing keeps up
- The area of corporate sustainability reporting is one of the areas that will further develop and mature in the upcoming years

The European Commission Action Plan

In their action plan on financing sustainable growth, the European Commission refers to sustainable finance as 'the process of taking due account of environmental, social and governance (ESG) considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities'. The above definition shows that there is a paradigm shift from purely looking at the profit as a key performance indicator to a broader view, which also includes environmental and social aspects.

In its action plan, the European Commission focuses on actions that will be undertaken for 2018 and 2019. Most of these consist of non-legislative measures, for example research or interaction with the European Supervisory Authorities (ESAs). However, some legislative proposals, issued in May 2018, find their basis in the action plan. For an overview of high-level initiatives announced in the EC Action Plan, see Exhibit 1. The initiatives can be grouped based on either:

- Initiatives that are focusing on changing products and services (product level) and,
- Initiatives that aim to change company policies and disclosures (firm level)

Exhibit 1: high-level initiatives announced in EC action plan

#	High-level initiatives	Level
A	Establishing an EU classification for sustainability activities to create clarity on the definition of sustainability	Product level
B	Creating standards and labels for green financial products to increase transparency on the real sustainability benefits of these products	Product level
C	Incorporating sustainability when providing investment advice to steer funds towards sustainable development	Product level
D	Developing sustainability benchmarks to help investors compare the carbon footprint of investments	Product level
E	Better integrating sustainability in ratings and research in order to facilitate a more sustainable allocation of capital and improve the information flow between issuers and investors	Product level
F	Clarifying institutional investors and asset managers duties to create transparency on sustainability performance to investors	Firm level
G	Incorporating sustainability in prudential requirements in order to better reflect sustainability risks in capital requirements	Product level
H	Strengthening sustainability disclosure and accounting rule-making to create transparency and ensure current regulation does not discourage sustainable investment	Firm level
I	Fostering sustainable corporate governance in order to attenuate short-termism in capital markets	Firm level

The European Commission wants to take a leading role in increasing the sustainability of the economy and financial system. In May 2018, the EC issued legislative consultations in the following four areas:

- a framework for sustainable investments (A),
- suitability assessments (C),
- benchmark regulation (D) and,
- disclosures relating to sustainable investments (F & H).

Various financial institutions, including fund manufacturers (e.g. investment funds) or issuers of bonds, as well as those managing funds for clients (asset managers) or advising on managing funds (wealth managers)[1] are expected to have an impact.

[1] In this article we will describe the impact of the legislative proposals on manufacturers, distributors and benchmark providers. This classification is well known from the PRIIPs regulation and reflects the current terminology used in the market

Exhibit 2: Legislative proposals announced in May 2018

| A. Sustainable investments framework

The purpose of the first consultation is to set a framework that defines 'sustainable' and 'green'. By creating a European label for sustainable investments, the Commission aims to:

- Enhance investor confidence by increasing visibility and comparability
- Prevent "Greenwashing"
- Increase efficiency in offering cross-border products

The framework should be worked out further by reports of the Technical Expert Group (TEG), which are expected in 2019, but has the potential to lead to a review of all products or services that are labeled sustainable. Delegated Acts based on these reports will be issued between 2020 and 2022.

| F & H. Transparency requirements

The second consultation aims to create transparency both on a product level (how does the product or service create positive impact or reduce negative impact) and firm level (what is the governance around sustainability and what policies and procedures are in place). By creating harmonized transparency requirements, the EC aims to:

- Create a level playing field
- Facilitate competition
- Increase comparability
- Prevent any distortions to a smooth functioning of the internal market

| D. Benchmark requirements

The third proposal will amend the existing regulation that sets standards for benchmarks and indexes. By amending the benchmark regulation to create two new categories of green benchmarks, the EC aims to:

- Allow for effective comparison across borders
- Ensure a high level of investor protection
- Remove and prevent obstacles to the efficient movement of capital into sustainable investments

| C. Suitability assessment

Next, to these consultations, the Commission is also seeking feedback on amendments to delegated acts of MiFiD II and the Insurance Distribution Directive (IDD), as it proposes to harmonize the way firms integrate ESG considerations into the suitability assessment.

Risks and Potential Impact

Exhibit 3 shows an overview of the action plan initiatives, the timelines depicting when certain legislative/non-legislative proposals will be launched, and a preliminary assessment of potential impact on fund creators like investment funds (M - manufacturers), fund managers such as asset- and wealth managers (D – distributors) and Benchmark Administrators (B).

Exhibit 3: potential impact of sustainable finance

Impact on processes

The additional transparency duties, along with the upcoming classification and labels for sustainability, might significantly change business processes for manufacturers of sustainable financial products. Distributors of sustainable financial products, like asset managers and banks, should also closely monitor the upcoming initiatives, particularly the initiative to incorporate sustainability in investment advice. For both manufacturers and distributors, this could lead to compliance risk and change risk. On the firm level, a first step has already been taken with the introduction of the EU Directive on non-financial information (NFI), which requires large public entities to disclose material information on key ESG aspects and related risk management practices. Our expectation is that with the area of sustainability further maturing, the disclosure initiatives and associated requirements will only continue to increase in the future.

Impact on financial instruments

Not only could the upcoming legislation significantly impact business processes, also the characteristics of the financial instruments that are at the core of the business.

Exhibit 4:

Bonds

The foreseen increase in the issuance of green bonds, together with an increased appetite for sustainable investments, potentially brings in relatively new auxiliary risks. Underlying investments related to sustainable projects, e.g. in renewable and clean energy, tend to be relatively capital intensive. Consequently, those projects require a longer earn-out period, translated into possible concentration risks along with the debt offerings shifting to longer maturity buckets, leading to potentially less certain cash flows. Furthermore, if investors are willing to pay premia for green bonds vs. grey bonds, this would require calibrating the premia against how increased incorporation of ESG characteristics in the underlying investments might reflect in credit risk.

Equities

Redefining and establishing equity benchmarks on sustainability, implicitly leads to redefining and establishing exchange-traded funds (ETFs) that track these indices. Firms need to be able to explain why a choice for a certain benchmark has been made. For active managers, this requires redefining their alpha while passive managers possibly face concentration risks when a limited number of investable assets is meeting a wave of new capital inflows. This could lead to increased volatility in ESG-related equities. For performance attribution and evaluation, as well as for reporting, firms need to succinctly incorporate clients ESG metrics, considerations and policies, besides the usual performance metrics, e.g. used for quarterly and annual statements. As it looks now, the upcoming legislative proposals require clarity on how well clients' ESG considerations are reflected in the portfolios and how this impacts risks and returns.

Real estate

Sustainability can potentially impact the future cash flows of real estate. For example, commercial real estate in Holland, which is required to have a minimum energy efficiency label of 'C' by 2023, based on the new energy performance certificate (EPC) regulation. All real estate with an energy label of less than 'C' that does not satisfy certain conditions can face an order to cease the use of the building, significantly dropping its value as collateral for loans. The example above shows that sustainable finance considerations can have real money impact on business and investments. In a very recent development, ECOFIN (the committee comprising finance and economics ministers from all EU members states) backed plans for mandatory ESG risk disclosure within three years. This also touches upon a 'green supporting factor' or a 'brown penalizing factor' for EU banks, which can directly impact real estate related lending.

Conclusion

The first legislative proposals of the European Union give an insight into the future of sustainability in the financial sector: sustainability (ESG aspects) is bound to become more and more important for investment related decision-making. The European Commission Action Plan defines legislative as well as non-legislative actions that will be undertaken for 2018 and 2019. Depending on the consultation process and other developments, investment funds, asset managers and wealth managers that offer sustainable funds as a product or as a service to their clients, are expected to be impacted. The characteristics of the underlying financial products (bonds, equities, real estate) included in funds, are expected to be affected by the legislative proposals, business processes relating to the product offering, or business process on a firm level like disclosure requirements. Synechron can help you monitor the developments in the sustainability landscape, assess the impact on your business and determine the right approach for compliance with the upcoming legislative proposals. Synechron has advised clients of all sizes throughout the financial industry on regulatory topics like MiFID II and Benchmark Regulation. For some clients this was advice only, for others we participated in their projects or completely managed their project for them. Our experience in all those cases: timely preparation is key, keep good track of assumptions and business decisions, and include your control framework in the design process from day 1. Sustainable finance is here to stay, and it is going to have a real & significant impact on your business.

Global Footprint

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