SNAPSHOT

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Giving you insight to what is on the EU agenda

The Good, the Bad and Sustainable Finance

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In 2018 sustainable finance was one of the big buzzwords coming out of Brussels in terms of new European policy. The EU's Sustainable Finance Package published last May was a global first, providing a major legislative initiative linking the sector to climate change, a consequence of the G20's Financial Stability Board commitment to re-orientate capital flows to sustainable investments. As the first tranche of the draft legislation heads towards adoption, the financial services team at FTI Consulting Brussels takes a look at the paradox of reforming financial markets against the inherent challenge of tackling the financial risk associated with climate change.

It's been over 120 years since Swedish chemist and future Nobel laureate Svante Arrhenius deduced that the combustion of coal and petroleum could raise global temperatures and would reach a point of no return. If he was around today, he would be surprised at how quickly his apocalyptic vision has come to pass. Global politics (with some exceptions), seem to acknowledge the threat arising from a planet that is getting hotter every year and that urgent action is needed to prevent catastrophic consequences. The influential 2018 report by the New Climate Economy estimated that the world will gain $26tn of benefits by 2030 if we take action. On paper, solving the climate-change problem is straightforward: the global economy needs to service its energy needs more efficiently and phase carbon out of its energy supply. But next to looking at high- carbon emitting sectors, the world is looking at global financial markets for fighting climate change - Revolutionary!

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European laws for sustainable financial markets

For the first time we see regulatory initiatives that aim at harnessing the potential of the financial sector to help transition towards a sustainable economy. The European Union (EU) has initiated a regulatory process that puts it at the forefront of international efforts to build a sustainable financial system. The goal is to re-orient private capital to more sustainable investments to meet the EU's 2030 Paris target, to limit global warming to well below 2°C. The European Commission (EC), the executive arm of the EU, published its landmark sustainable finance legislative package in 2018 — the first of its kind worldwide. The package comprises three different legislative proposals that each try to incentivise different actors in financial markets to engage in a more sustainable way. The first proposal would help label activities to be green and provide a reliable classification system to market participants. The second proposal requires extensive disclosure requirements regarding the integration of sustainability risks by asset managers and investment advisers. Lastly, the European Commission looks at the global benchmark industry and proposes a law that introduces new categories of low-carbon and positive carbon benchmarks that should serve investors who wish to invest more sustainable. All legislative proposals are currently undergoing legislative scrutiny, with a high likelihood of adoption for two of the proposals in the current legislative term which ends in May 2019.

Adam Smith vs Climate Change

Traditionally, finance focuses on financial return and risk. The emergence of the modern market economy follows Adam Smith's economic theory of a decentralised economy with an "invisible hand" in a non-regulated economic allocation process. Rational individuals who maximise their own utility will ensure the optimal allocation of resources and goods. But Adam Smith did not witness the (*unusually hot*) summer of 2018. Climate change does not fit Smith's economic theory anymore, as it is influencing markets, productivity, and the allocation of resources. An invisible hand is not doing the trick in reallocating capital from less green to more sustainable economic activities and sectors by itself. Climate change has become a real economic threat that needs a regulatory response.

A Case for Sustainable Finance

The European Central Bank announced that climate-related risks are among the key drivers affecting the euro banking system. A major climate change related risk is caused by the transition to a low-carbon economy and the consequent re-evaluation of carbon-intensive assets such as oil deposits or coal mines. Such transitions could mean that some sectors of the economy face higher costs of doing business. Extreme weather conditions like droughts and heatwaves have an impact on entire supply chains that go beyond only one sector i.e. crop shortfalls put upward pressure on food prices. Hurricanes and floods destroy production capacity, and cold winters can result in productivity shocks, by raising input prices for the same level of output. So, much like other supply shocks, weather-related disturbances pose a dilemma for monetary policies, which may then have to choose between stabilising inflation or economic activity. Thus, integrating environmental, social, and governance (ESG) factors into business and investment decisions will be crucial for a society at large. This is what sustainable finance is all about. It should consider financial, ESG returns in combination. The ultimate mission is to ensure that environmental and natural capital is valued the same way as financial capital. One should not exclude the other.

Addressing the Paradoxes

While the ambition of the European Commission's sustainable finance package is laudable, the means may be debated considering the desired effect. Looking at financial market participants when it comes to sustainable finance makes sense, but we should make sure to consider investor thinking as well.

Mark Carney, Chairman of the Bank of England underlined the importance of incentivising a change of thinking by the entire financial value chain when talking about two paradoxes that are inherent to the financial risk of climate change.

The first paradox is that of the *"I don't care what happens after me"* attitude. Climate change imposes a cost on future generations that the current one has no direct incentive to fix and once climate change becomes a real danger to financial stability it may be too late to stabilise the atmosphere. Accordingly, the European Commission's legislative proposal which imposes disclosure rules on asset managers should go hand in hand with the continuous financial education of the end investor. Individual investors like millennials need to step up their demand for sustainable investments. It is about caring as an investor more than it is about disclosing how green a fund may be. Ultimately investor thinking drives supply and investment. Asking for disclosure on how sustainability risks are considered in investment strategies of fund managers is only one half of the coin. Although we can see growing awareness for ESG friendly investment strategies in some asset segments, sustainable financial literacy should be nurtured throughout the sustainable finance transformation process the EU is striving for.

The second paradox is the *"we don't want to move too fast"* paradox. Carney, like others acknowledges that if we move too fast towards a low-carbon economy we could materially damage financial stability. Smooth adjustment is crucial because transition risks could turn into failure. The legislative proposal on low-carbon and positive carbon benchmarks has done just that. It is too early to set out prescriptive minimum standards for low-carbon and positive carbon impact benchmarks because of the lack of consensus in the ESG research community on how to measure sustainability and the alignment of benchmarks with the Paris targets without a consistent methodology for measuring success or failure. Benchmarks don't drive supply but merely mirror market conditions. The proposal seems to be ahead of the available ESG research in this regard. Until reliable and concise data and methodologies are available, benchmark administrators will not be able to create these benchmarks, or if they do, they do not mirror market reality and investors will shy away from them.

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These two paradoxes need to be addressed adequately by legislators at an early stage of the transformation process. The sustainable finance package by the European Commission though an important first step in addressing crucial players in financial markets, needs to be supported by investors who understand that they do not give up financial upsides just because of sustainable investment objectives. For a successful EU sustainable transformation strategy to happen, a change in thinking should be the start, followed by a steady and secure transition ultimately serving the economy and financial markets. And who knows, perhaps like this, sustainable finance becomes the new normal and not just a Buzzword or catchphrase after all.

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