

Financial regulation is moving to a new and very burdened political field and is painted green. Investor demand for ESG investment products is on the rise. Banks and corporations, often under pressure from their governments, are committed to shifting their focus to activities with lower carbon emissions.

However, it is not clear whether these private sector commitments are sufficient to achieve the necessary transition; and given uncertain regulatory environments, there are high risks of misrepresentation and greenwashing. This also has the potential to foster international rivalry, given the effects these regulatory reforms may have on the global distribution of capital. The Sustainable Financing Regulatory Plan therefore carries a significant risk of geoeconomic tensions that could undermine cooperation and climate change mitigation.

This brief overview aims to clarify the contours of the green regulatory field and provide an overview of existing initiatives. He considers three main approaches to green regulation, explaining the philosophy underlying each of them, and the emerging political dynamics among them. These three approaches are: (i) taxonomies (ie defining economic activities that are sustainable, and / or unsustainable, and / or which activities potentially fall between them), (ii) data disclosure rules, and (iii) sustainability reporting standards (the latter two relate to standards that compel private sector actors to disclose information, with varying degrees of detail, about the relationship between their activities, climate risks and other sustainability risks).

These three approaches are not mutually exclusive. Each of them is based on a different philosophy, but in principle they are complemented by addressing different needs in the area of sustainability policy or in the value chain.

This field is already very fragmented. There are a number of existing approaches and actors on all three fronts. In addition, although these three approaches are not mutually exclusive, some actors or countries are positioned, or perceived, as champions in one approach versus another. This encourages competition between the main jurisdictions involved (EU, US, UK, China), which have a strong interest in setting global sustainability standards, given the potential geoeconomic implications.

Talks at the G7 / 20 level this year, especially between the US and the EU, are key to achieving a certain level of international cooperation in this area, ideally for all three pillars. This is essential to enable the fastest possible energy transition and ensure that current growth in approaches and standards does not create greater opportunities for international regulatory arbitrage and greenwashing.

Prescriptive approach: taxonomy

The first approach to green financial regulation consists in creating a classification of economic activities according to their sustainable, or unsustainable character (ie taxonomy). This tool can be used for multiple purposes, at the level of governments, the financial sector and the corporate sector. Particularly:

> It can encourage public and private investment towards sustainable economic activities, thus creating, strengthening and / or deepening related markets.

For example, the first taxonomy has its roots in China, where the growing green bond market (China is one of the largest issuers of green bonds in the world) led the National Bank of China to create a “catalog of projects approved under green bonds in 2015, often referred to as Chinese taxonomy.

> In contrast, it can identify greenwashing investments and initiatives, whether initiated by private actors or governments.

> It can be included in the prudential regulations of financial institutions, to encourage the financial system to align its balance sheet with activities that support climate security or transitional activities (eg by introducing additional capital penalties if the bank continues to finance unsustainable activities).

> It can also be involved in public financial management, to help monitor the climate impact of national budgets, especially public expenditure. This encourages transparency and accountability. It also helps countries link their medium- or long-term commitments to reduce emissions or achieve zero emissions through short-term spending and planning.

Taxonomies are a highly normative approach to green regulation, and the philosophy that supports them is that public bodies (central banks, legislators and regulators) have a responsibility to press prescribed standards on all economic actors and, ultimately, redirect financial flows towards sustainable economic activities. Precisely because it is normative, this approach is complex and fraught with political difficulties, as the public authority in charge of developing the taxonomy must make fairly binary decisions about sustainability and the path to sustainability.

Numerous jurisdictions have created or are creating taxonomies. They all look different and have different purposes. In addition to the European Union, China, Japan, Russia, Canada, and numerous Asian and Latin American economies have established or are working to establish some kind of taxonomy.

The European Union positioned itself early as a leader in this area (even if it was not the first driver), with clear ambitions to use its taxonomy to become a global creator of standards in green regulation. The opportunity to play a global role was increased by the

Trump administration, which was not interested in international coordination, and especially in sustainable finance. As a result, on October 18, 2019, on the sidelines of the annual meeting of the International Monetary Fund (IMF) / World Bank in Washington, the European Union launched, together with Argentina, Canada, Chile, China, India, Kenya and Morocco an International Platform for Sustainable Finance (IPSF). The United States did not join the IPSF. Shortly afterwards, the EU set up a working group, which it chairs with China, with the aim of identifying common points among existing global taxonomies - work that could ultimately serve as a basis for creating a global framework for taxonomies. The report on this work is expected to be published in the second half of 2021. On July 6, 2021, the EU published its Strategy for Financing the Transition to a Sustainable Economy. It has a section entitled "Promoting an ambitious consensus in international forums", which confirms the EU's ambitions to become a global creator of standards for taxonomies, as well as wider green financial regulations. Importantly, he notes that "the EU is actively involved in the G20 and the International Platform for Sustainable Finance in order to avoid fragmented approaches".

It is unclear, however, to what extent this European leadership potential can be fully realized.

Transparency, flexibility and market adjustments: sustainability frameworks for data disclosure

Another dominant approach to green regulation is rooted in the importance of developing a data disclosure framework, both by the financial sector and central bank governors, and by the corporate sector. The aim is to develop a general framework based on principles that can be used by all types of companies to disclose information to the market, mainly on how the company manages climate risk.

There are two logics of this approach. The first is the ability to assess and quantify climate-related risks, especially for the financial sector, in order to allow for appropriate stress testing or surveillance actions, thus protecting financial stability. The second is to provide information to the market so that both risk and impact can be adequately assessed and capital oriented accordingly. The basic belief is that transparency and disclosure of data will enable price signals and necessary market adjustments towards sustainable companies and activities, directing investment flows towards those companies that integrate climate risk into their business model, management and corporate processes, encouraging companies to address climate risks. a more complete and sophisticated way.

In 2015, the Financial Stability Board (FSB) established a Working Group on Climate Financial Disclosure (TCFD), to develop guidelines for voluntary disclosure that will be used by companies in all sectors. The Bank of England played an important role in guiding the work and recommendations of the TCFD and helped promote it as an internationally accepted standard, as Mark Carney was both Governor of the Bank of England and Chairman of the Financial Stability Board. The final disclosure guidelines are structured around four broad pillars. The guidelines encourage companies to disclose relevant metrics and objectives, as well as information on how climate risk is involved in management, strategy and risk management.

Today, TCFD is the dominant player in the field of data discovery. Since September 2020, over 1,500 companies worldwide have followed TCFD recommendations.

The concept of materiality, a potential bridge between a market-oriented approach and taxonomy?

Sustainability accounting standards

The discussion on disclosure frameworks and the emergence of the TCFD has accelerated the discussion on sustainability reporting standards.

Disclosure frameworks and sustainability accounting standards can be viewed hand in hand or overlapping. It is difficult to distinguish disclosure frameworks from accounting sustainability standards, but the proliferation of voluntary initiatives in this area has forced actors to draw lines in the sand. Attempts by the Board of Accounting Sustainability Standards to distinguish between the two consist of viewing disclosures as broad guidelines, while standards would be more detailed and specific. The overlap between them reflects certain discussions that have taken place between regulatory requirements and accounting standards for the financial sector in the past. They reflect the interests of different actors who look at similar issues through different lenses, but they are important because these actors are not equally equipped for international cooperation. Indeed, accounting standard-setting bodies have dealt with international debates and convergence for decades, while oversight bodies have historically had a much greater national preference.

One key issue that has structured the debate on accounting standards for sustainability - and in relation to which the different actors involved in this debate have positioned themselves differently - is the issue of materiality. Materiality is an accounting concept that identifies the type of information that is considered important or “decisive” for the company itself, the business sector in which it operates and investors.

According to the International Accounting Standards Board, information is considered material if “its omission, misstatement or obscurity would affect the decisions that primary users of general purpose financial statements make based on those financial statements”.

Policy in this area is evolving very rapidly. On April 21, 2021, the European Commission adopted a proposal for a Directive on Sustainable Corporate Reporting (SFRD), which changes the existing reporting requirements under the EU Directive on Non-Financial Reporting (known as NFRD). The proposal introduces a requirement in line with mandatory EU sustainability reporting standards. Very logically, given the taxonomy, the SFRD relies on a dual materiality approach. In addition, the European Commission has requested that the European Financial Reporting Advisory Group (EFRAG) prepare technical work and contribute to European delegated acts through which sustainability reporting standards will be adopted. EFRAG advises the European Commission on the acceptance of international accounting standards (International Financial Reporting Standards or IFRS; in EFRAG’s own words, it considers whether these standards “serve the European public interest” and whether their adoption would “affect the European public good”).

Conclusions and recommendations

Addressing the challenges of climate change at the right pace requires the greatest possible ambition in addressing the risks of greenwashing and fragmentation, as well as redirecting all flows towards sustainable activities. It seems unlikely that the market alone can manage the quantum leap needed to redirect existing socio-economic structures towards a model that is more climate-safe. Ideally, what needs to be achieved is ambitious cooperation on three pillars – taxonomy, publishing and reporting standards. A more realistic goal would be to create minimum global guidelines.

In this context, taking into account the positions of the main actors in this area, three main conclusions and recommendations emerge:

> First, the EU should use its alignment with China in the field of taxonomy to stimulate global discussion on this issue in 2021. China and the EU have worked closely on this issue in the context of the International Platform for Sustainable Finance. At the same time, it is not clear how the taxonomies will be presented in the October report of the G20 Sustainable Finance Working Group, co-chaired by the United States and Lina. The EU should use the coordination achieved with China on this issue to ensure, at a minimum, that the issue of creating a global basis for taxonomies is raised in the report, and at best that this issue is addressed on the basis of work already done by the EU and China.

International platforms for sustainable finance.

> Second, individual EU members should use their diplomatic engagement with the US and channels of cooperation with the US Treasury to encourage the US on taxonomy. At the very least, they should encourage the United States to clearly address the issue of global coordination in the field of taxonomy in the context of the G20. Ideally, and as a result of this diplomatic engagement, the United States should also join the International Platform for Sustainable Finance. That would give a strong and positive signal that the United States, after four years of absence, is ready not only to engage in these issues, but also with a clear intention of maximum cooperation.

> Finally, as far as reporting standards are concerned, EFRAG and those who set the standards should continue to set double materiality. A global basis for reporting standards rooted in double materiality will be needed to complement the disclosure rules. Meanwhile, while the IFRS Foundation is working to create a global framework for sustainability reporting, it should seek to integrate all the work already done in this area. At a minimum, the IFRS Foundation should determine how reporting standards fit together and conduct an open process in elaborating its standards. At this point, it is clear that the IFRS Foundation is not moving towards an approach rooted in double materiality. Nevertheless, it should fully recognize the importance of this debate and propose to conduct a process of revision of its reporting standards two years after they are finalized in order to possibly update its approach.

Source: e3g.org