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06.

Sustainable Finance

Promoting a more sustainable, stable global financial system

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I. Context: connecting **sustainability** and **financial stability**

Financial supervisors have been taking a closer interest in the impact of climate change and other sustainability issues on financial stability

Ahead of the Paris climate agreement in 2015, Bank of England Governor Mark Carney set out in his defining **'Breaking the Tragedy of the horizon'** speech that climate change would impact financial stability in terms of:

i. **Physical** risks - direct costs of increasing extreme weather events
ii. **Transition** risks - sudden, sharp losses in value in the fossil fuel sector as the energy transition takes place) and
iii. **Liability** risks- costs due to legal action by those suffering the effects of climate change

This speech, and the accompanying BoE analysis, has continued to frame much of the discussion.

Connecting sustainability and financial stability

“Climate change is a

tragedy

of the

horizon

Which imposes a cost on future generations that the current one **has no direct incentive to fix.”**

Mark Carney, April 2018

Since 2015, multiple supervisors have continued to examine the connection between sustainability and financial stability

European Systemic Risk Board

In 2016 the ESRB Advisory Scientific Committee published a report: *Too late, too sudden: Transition to a low-carbon economy and systemic risk*

The study found:

- a sudden transition away from fossil-fuel energy could harm GDP
- there could be a sudden repricing of carbon-intensive assets
- there could be a rise in the incidence of natural catastrophes, raising general insurers' and reinsurers' liabilities.

Financial Stability Board

In 2015 the FSB launched the industry-led Task Force on Climate-related Financial Disclosures (TCFD) to develop recommendations on climate-related financial disclosures.

The Task Force found that disclosure of climate-related financial information is a prerequisite for financial firms to manage and price climate risks appropriately but also, if they wish, to take lending, investment or insurance underwriting decisions.

Dutch Central Bank

The Dutch Central Bank published a report *Waterproof?* in 2017.

The report finds that financial institutions must increasingly **factor in the consequences of a changing climate and the transition to a carbon neutral economy**.

The DNB intends to embed climate-related risks more firmly in financial supervision with the aim of ensuring sustainable financial stability.

Sustainable Insurance Forum

The SIF was formed in 2016 as a network of leading insurance supervisors and regulators.

Members seek to **strengthen their understanding of and responses to sustainability issues for the business of insurance**.

It is a global platform for **knowledge sharing, research and collective action**.

II. **The EU and Sustainable Finance**: The High Level Expert Group and Beyond

In 2016, the EU established a **High Level Expert Group on Sustainable Finance** to examine how to make the EU's financial system more sustainable.

The expert group's final report in 2018 made multiple recommendations, including to:

- **Clarify investor duties** to better embrace long-term horizon and sustainability preferences
- **Upgrade disclosure rules** to make sustainability risks fully transparent, starting with climate change
- **Include sustainability in the supervisory mandates** of the European Supervisory Authorities (ESAs) and extend the horizon of risk monitoring
- **Empower citizens** to engage and connect with sustainable finance issues through financial literacy and other measures
- Leverage EU action **to enshrine sustainable finance at global level,** by using EU influence globally
- Encourage sustainability **by insurance companies, banks, and other key financial institutions**

The EU High Level Expert Group on Sustainable Finance

The European Commission Action Plan on Sustainable Finance

In March 2018 the European Commission responded to the HLEG report with on **Action Plan on Sustainable Finance**

The Action Plan included a variety of legislative and non-legislative measures, including:

- **Clarification of investor duties** to explicitly include addressing sustainability issues
- **Instructing EU supervisors to explore reforms to the EU prudential frameworks** (including capital calibration) for banks and insurers (see detail in following slide)
- **Strengthening rules around climate disclosure** in line with the recommendations of the Task Force on Climate-related Financial Disclosure
- **Developing a taxonomy** to identify sustainable (and, potentially non-sustainable) assets
- **Standards for green bonds** – and, eventually, other assets
- Embedding sustainability more firmly into **corporate governance**

The Commission is looking to introduce or set in motion as many of these as possible before the end of its mandate

In May 2018, the Commission followed up the Action Plan with a first set of **detailed proposals**

The key features of these measures are:

1. **A unified EU sustainability classification system ('taxonomy')**: sets harmonised criteria for determining whether an economic activity is environmentally-sustainable. May serve as the basis for the future establishment of standards and labels for sustainable financial products.
2. **Investors' duties and disclosures**: proposed Regulation to introduce consistency and clarity on how institutional investors should integrate environmental, social and governance (ESG) factors in their investment decision-making process. In addition, asset managers and institutional investors to demonstrate how their investments are aligned with ESG objectives and disclose how they comply with these duties.
3. **Low-carbon benchmarks**: to create a new category of benchmarks, comprising the low-carbon benchmark or "decarbonised" version of standard indices and the positive-carbon impact benchmarks.
4. **Better advice to clients on sustainability:** a consultation to assess how best to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients. The aim is to amend Delegated Acts under the Markets in Financial Instruments Directive(MiFID II) and the Insurance Distribution Directive.

Commission May 2018 detailed proposals

Commission Action Plan prudential recommendations

Action 8 in the Commission's Plan specifically relates to prudential regulation (p.10)

Action 8: Incorporating sustainability in prudential requirements

1. **The Commission will explore the feasibility of the inclusion of risks associated with climate and other environmental factors in institutions' risk management policies and the potential calibration of capital requirements of banks as part of the Capital Requirement Regulation and Directive.** The aim would be to take into account such factors, where this is justified from a risk perspective, to safeguard the coherence and effectiveness of the prudential framework and financial stability. Any recalibration of capital requirements, based on data and the assessment of the prudential risk of banks' exposures, would need to rely on and be coherent with the future EU taxonomy on sustainable activities (see Action 1).
2. **In Q3 2018, the Commission will invite the European Insurance and Occupational Pensions Authority (EIOPA) to provide an opinion on the impact of prudential rules for insurance companies on sustainable investments,** with a particular focus on climate change mitigation. The Commission will take this opinion into account in the report to be submitted to the European Parliament and Council by 1 January 2021 under the Solvency II Directive.

The Action Plan left out a few important recommendations/ details from the Expert Group that we think worth revisiting

Key Expert Group recommendations that should be built upon

Putting the EU citizen first

We need to rebuild EU citizens' trust in finance by helping them understand the financial system through **promoting financial literacy and other measures**

Sustainable prudential regulation

The Action Plan asks the ESAs to look into sustainable prudential regulation but provides little detail; **the Commission should look to the detailed recommendations on promoting sustainable long-term finance in the HLEG report** (see following slide), particularly through considering capital recalibration based on long term risk.

A World Benchmarking Alliance

The Commission should deliver on the recommendation of the HLEG that it should join others **in "endorsing, giving expertise and helping fund the World Benchmarking Alliance (WBA) as an independent organisation building free public rankings", and "promote greater financial literacy on sustainable finance"**

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We recommend that, when following the Commission's invitation to "**to provide an opinion on the impact of prudential rules for insurance companies on sustainable investments**", EIOPA take into account the HLEG insurance recommendations

High Level Expert Group Insurance Recommendations

- **Solvency II reviews: investigate how Solvency II could be adapted to facilitate further long-term investment while maintaining a strong risk-based nature.**
  - **Assessment of alternative ways to deal with prudential concerns about forced selling of assets:** Forced selling can be a real risk for some insurance companies, but the current approach implies that the entire asset base is exposed to forced selling. More appropriate ways of capturing the actual magnitude of this risk for insurance companies should be investigated.
  - **Assessment of alternative ways to set discount rates to avoid exaggerating liabilities and balance sheet volatility.** Measures of the LTG package (Matching Adjustment, Volatility Adjuster) seek to address this challenge and can constitute efficient tools. They should continue to be part of the 2020 review of the prudential framework, including with refinements to capture cases of artificial volatility more effectively.
  - **Examination of how long-term investment risk can differ from short-term trading risks and how this difference can be reflected in solvency capital charges, while ensuring that overall capital requirements do not increase.** This could lead to alternative ways of calibrating long-term investment risk and, in cases where this is justified by robust analysis, to the introduction of lower capital requirements for green investments.
  - **Ensuring that the European Insurance and Occupational Pensions Authority's (EIOPA) response** to the Commission's request for technical advice on 'unjustified constraints to financing' considers the ways in which the current system gives disincentives to green finance in unrated bonds and loans, as well as in unlisted equity.[70]

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High Level Expert Group Insurance Recommendations

We recommend that, when following the Commission's invitation to "**to provide an opinion on the impact of prudential rules for insurance companies on sustainable investments**", EIOPA take into account the HLEG insurance recommendations

- **Disclosures: encourage greater adoption of the TCFD recommendations.**
  The coming years will allow for an assessment of how the TCFD framework has been adopted and its impact on companies, investors and analysts. The Commission can clearly support the proportionate implementation of the TCFD framework by the insurance sector, as the strengthening of disclosure on climate-related risks and opportunities will also strengthen companies' internal command on this topic. Depending on how the process is assessed, the Commission could eventually consider how to integrate proportionately the recommendations of the TCFD into the reporting regimes for financial services companies.

- **Supervisory review: assess the need to incorporate climate risk more explicitly into assessments conducted by insurance companies.**
  Assess if and how the supervisory reviews need to be more explicit in including climate-related risks, as well as mitigation and adaptation policies. This could concern both the asset and liability sides of the balance sheet.[69] In this context, consideration could be given as to whether it would be appropriate to develop common climate risk scenarios to help ensure that company assessments of climate risks are consistent and comparable.

III. **Going global**: what's next for sustainable finance?

What’s next?

While the EU continues to take a lead on sustainable finance, others are also acting.

For example:

- A 2017 UN study found **300 policy measures promoting sustainable finance in 54 jurisdictions**, with a substantial rise in system-level initiatives. By comparison at the end of 2013, 139 policy and regulatory measures were in place across 44 jurisdictions.
- The **UK’s Green Finance Taskforce** has in 2018 made a comprehensive set of recommendations to the government on greening the British financial system
- The **TCFD** continues to grow its support and we are starting to see the first set of detailed company disclosures

What's next: Benchmarking - Unlocking the power of companies through capital markets and society

World Benchmarking Alliance

www.worldbenchmarkingalliance.org

The UN Sustainable Development Goals set out the future we want. The private sector will be central to their success.

The World Benchmarking Alliance will develop, fund, house and safeguard publicly available corporate SDG performance benchmarks.

Free corporate benchmarks aligned with the SDGs will help companies, investors and others drive change by raising awareness and promoting a corporate race to the top.

Successful benchmarks provide guidance on impact as well as a gap analysis. This improves understanding, promotes dialogue and drives positive change.

The WBA is itself a Partnership for the Goals (Goal 17) and includes representatives from finance, business, civil society, and government.

Sustainable Investment and insurance: developments

1994 | 1995 | 2001 | 2006 | 2007 | 2010 | 2012 | 2014 | 2015 | 2016 | 2017

1994: Aviva Investors among first asset managers to publish Corporate Governance Voting Policy

1995: At UN Summit Aviva pledges to 'balance of economic development, the welfare of people and a sound environment, by incorporating these considerations into business activities'

2001: Aviva Investors founding CDP signatory (previously Carbon Disclosure Project) & first asset manager to formally integrate corporate responsibility to voting policy

2006: Aviva Investors is founding signatory of the Principles for Responsible Investment

Aviva is first global insurance group to go carbon neutral

2007: Aviva is founding signatory to ClimateWise and Accounting for Sustainability Principles

2010: Aviva Investors in vanguard of signing the UK Stewardship Code

2012: Aviva Investors founded Corporate Sustainability Reporting Coalition with call to action at Rio+20 Conference

Aviva is founding signatory of Principles of Sustainable Insurance

2014: Launched Aviva Roadmap for Sustainable Capital Markets & Sustainable Capital Markets Manifesto

2015: Mark Wilson speaks at UN General Assembly on Sustainable Finance

Aviva published Strategic Response to Climate Change & actively participated in COP21

Aviva Investors joined Investor Forum Board

PRA Climate change Adaptation Report

2016: Aviva Investors asked to join the Financial Stability Board Taskforce on climate-related financial disclosures

2017: Aviva Investors asked to join European Commission's High Level Expert Group on Sustainable Finance

Aviva discloses against TCFD recommendations

Industry momentum on sustainable finance

Thank you