SUSTAINABLE FINANCE

-

REGULATORY FRAMEWORK AND ITS IMPLICATIONS

21 June 2023

ESG INVESTMENT & FINANCE Summer Programme

Academic Year 2022 - 2023

Index

INTRODUCTION

Introduction

What is sustainability?

In ecology sustainability describe how biologycal systems remain productive over time.

Sustainable development is a term coined since Brundtland's 1987 report, drafted by the UN, by Dr. Gro Harlem Brundtland, and which was originally called "Our Common Future".

"Sustainability is governed by the principle of ensuring the needs of the present without compromising the needs of future generations, ***always without renouncing environmental protection,*** *economic growth and social development.“*

Dra. Gro Harlem Brundtland

Introduction

Is sustainability important?

"Europe can lead by the power of its example. ***Europe has become the home of sustainable investment****. This is a leadership we are proud of, and we will keep consolidating."*
Ursula Von der Leyen- October 2021

"The ***sustainability transition*** *requires a collective effort of several parties. Our role as regulators and supervisors is to* ***make sure that there is a sound regulatory regime****, and that timely action is taken when there is a threat to investor protection or the overall stability of the financial system."*
Verena Ross- November 2021

"The ***advent of sustainability*** *has undoubtedly brought about* ***the biggest transformation in*** *public and private* ***finance*** *in the last 30 years"*
Rodrigo Buenaventura- September 2021

Introduction

General Background

United Nations

International Covenant on Civil and Political Rights

Sustainable Development Goals

1948

1966

2011

2015

Universal Declaration of Human Rights

Guiding Principles on Business and Human Rights

COP
1997- **Kyoto Protocol**
2015 - **Paris Agreement**

Introduction

General Background

Sustainability has become a generational challenge that requires:

POLITICAL COMMITMENT → **LEGISLATIVE DEVELOPMENT** → **ECONOMIC INVESTMENT**

Introduction

General Background

PARIS AGREEMENT 2015

Goal

Substantially reduce global greenhouse gas emissions and redouble efforts to stay within the 1.5-degree mark by the end of this century and achieve climate neutrality by 2050.

Today, 193 countries (192 countries plus the European Union) have joined the Paris Agreement.

ACTION PLAN 2018

10 key actions

- ✓ Taxonomy of sustainable finance
- ✓ Green bond standard
- ✓ Encouraging investment in sustainable projects
- ✓ Sustainability in financial advisory services
- ✓ Benchmark labels
- ✓ Sustainability in credit ratings
- ✓ Asset managers and institutional investors
- ✓ Prudential rules
- ✓ Elaboration of accounting rules
- ✓ Promotion of corporate governance

EUROPEAN GREEN PACT 2020

Proposals to adapt EU policies on climate, energy, transport and taxation

- ✓ Mobilising at least €1 trillion in sustainable investments over the next decade
- ✓ Carbon neutrality by 2050
- ✓ 50-55% reduction 2030

Introduction

The role of financial markets

Financial markets play an important role in the transition towards a more sustainable and inclusive growth

- ✓ **Reorienting capital flows to facilitate more sustainable and inclusive growth**
- ✓ **Managing** financial risks arising from climate change
- ✓ **Promoting transparency and long-term vision in financial and economic activities**

“The financial markets are at a point of change with investor preferences shifting towards green and socially responsible products, and with sustainability factors increasingly affecting the risks, returns and value of investments […]”

Steven Maijoor – Febrero 2020

Introduction

What is sustainable finance?

Sustainable Finance means any financial activity or service that integrates environmental, social and governance (ESG) criteria into business or investment decisions for the benefit of clients and society

Environmental criteria: beneficial activities to the environment (as water purification technologies or renewable energies), or reduction or mitigation of negative externalities on an entity's environment (as internal control systems for energy use or reduction of carbon emissions).

Social criteria: entity impact on workers, consumers and communities in which it operates or are affected by its operations. Social criteria seek, among other objectives, to reduce discrimination and inequality through good business practices and the inclusion of the most disadvantaged groups in their decision-making and due diligence duties.

Governance criteria: issues of corporate governance of the company and its corporate culture. Examples of good governance are accountability, the independence and composition of the governing bodies, the remuneration of its executives, the gender pay gap, lobbying practices, the fight against corruption, or transparency and fiscal responsibility.

Introduction

What is greenwashing?

Greenwashing refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met

HSBC advert at bus stop in UK, 2021

HSBC faces greenwashing accusations from UK advertising watchdog (April 29, 2022):
The Advertising Standards Authority (ASA): judged that the effect of the two adverts was to lead customers to believe that HSBC was making "a positive overall environmental contribution as a company".
As evidence, the ASA cited information from HSBC's annual report, which disclosed that its current financed emissions equated to 35.8mn tonnes of CO_2 per year for oil and gas projects alone. It also noted that HSBC will continue to finance thermal coal mining until 2040.
Source: Financial Times

CEO of Deutsche Bank's asset manager steps down after 'greenwashing' raid (June 1, 2022): The chief executive of top German asset manager DWS steps down a week after raids by prosecutors over allegations that the company misled investors about "green" investments.
German officials have been investigating reports and a whistleblower's allegations that DWS had **exaggerated the green credentials** of investments it sold — a practice known as greenwashing. DWS has repeatedly denied that it misled investors.
Shares in DWS have slumped 26% since the SEC and BaFin investigations were **made public** in August last year. They were **down about 7%** on the **day of the raid**.
Source: CNN

BACKGROUND

Background

EU priority: the transition towards a **greener and more sustainable economy**.
ESMA: aims to ensure that the **financial markets support and promote** this **shift.**
European Commission (EC) has put in place **three building blocks** for a sustainable finance system**:**

- The development of a **classification system** for **sustainable activities**;
- A comprehensive **disclosure framework** for financial and non-financial entities; and
- A set of **clear standards** and labels

In July **2021**, the **EC** published a Renewed Sustainable Finance Strategy, that establishes four main areas:

- **Financing** the transition of the real economy towards **sustainability**;
- Moving towards a more **inclusive sustainable finance framework**;
- Improving the **financial sector's resilience** and **contribution** to sustainability; and
- Fostering **global ambition**

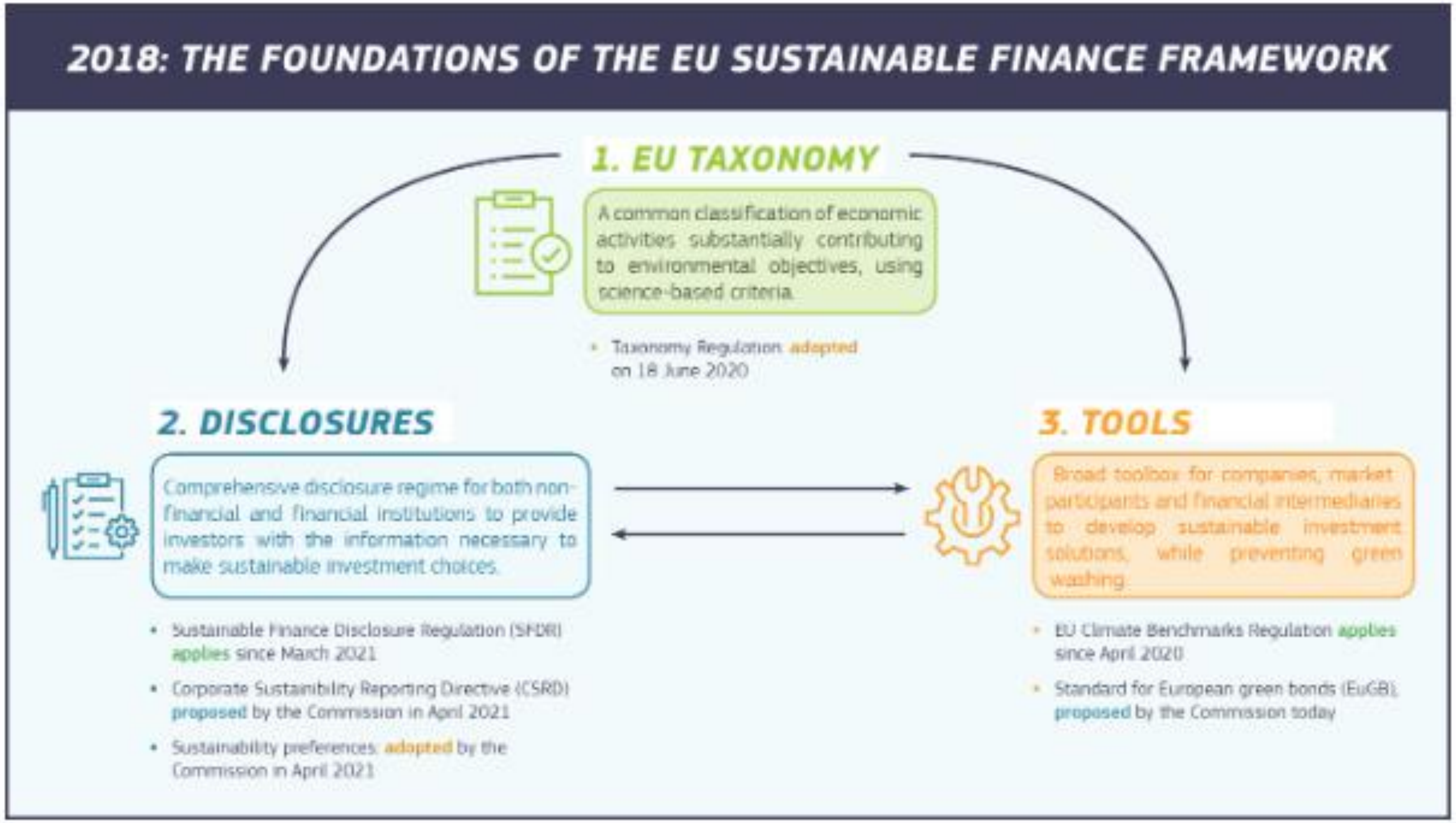
*"To say that the **demand for sustainable financial products** is **strong** is to state the obvious"*

"ESMA is determined to help in the pursuit of the transition towards sustainable finance and where possible to provide guidance to address some of the outstanding challenges. In doing so, we will be driven by the need to increase comparability, reduce complexity and, more broadly, to ensure that investors get the right picture to make informed choices about how to best engage in sustainable investing

Verena Ross, ESMA Chair – 24 October 2022

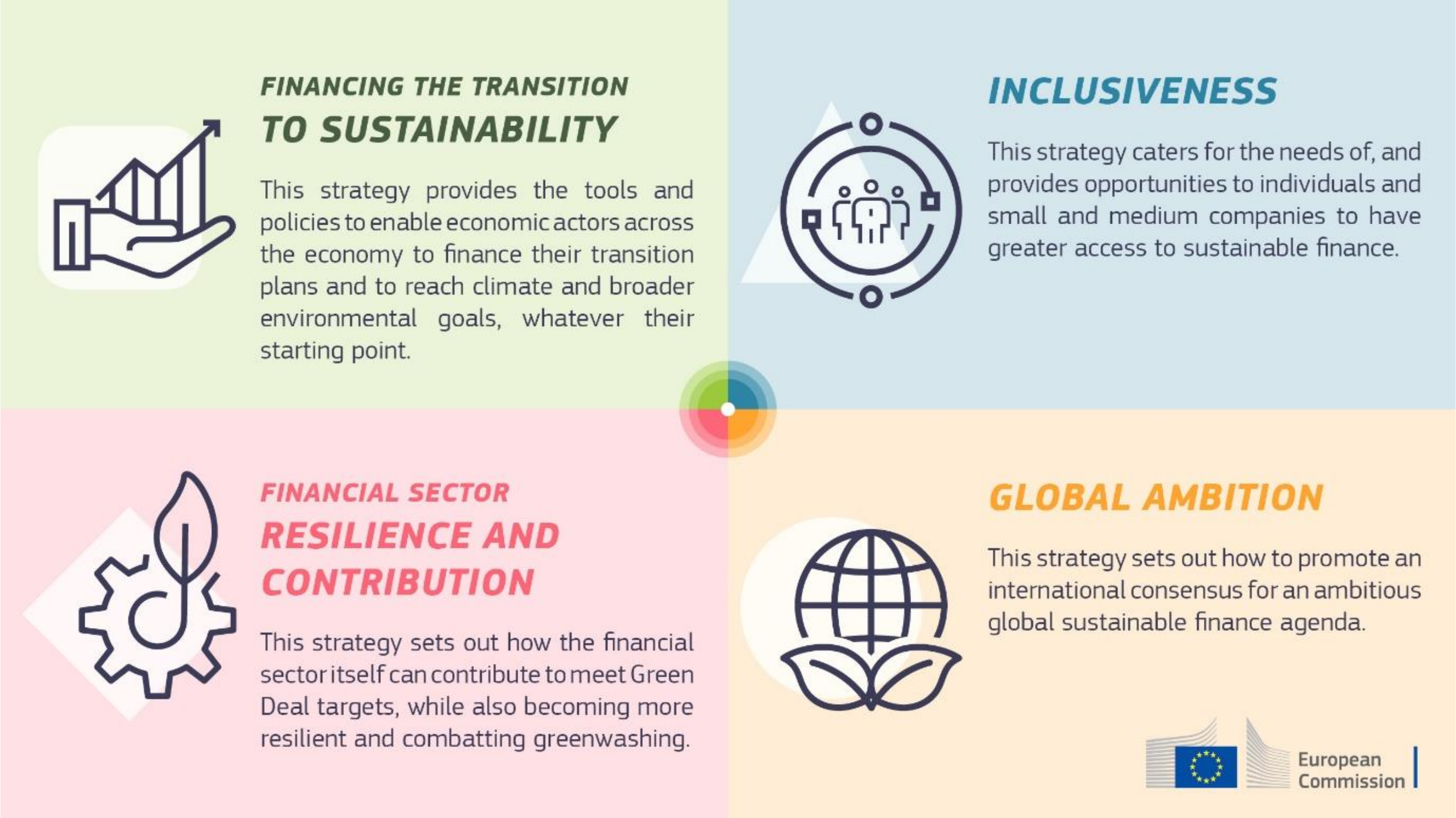
Background

Sustainable Finance Strategy- 2018



Background

Renewed Sustainable Finance Strategy - 2021



Background

EU Sustainable Roadmap 2022-2024

- **Roadmap:** tool to ensure coordination and transparency on ESMA´s sustainable finance derivables. See details
- Priorities:

  Tackling greenwashing and promoting transparency
  Greenwashing is a complex and multifaceted issue which takes various forms, has different causes and has potential to detrimentally impact investors looking to make sustainable investments. Investigating this issue, defining its fundamental features and addressing it with coordinated action across multiple sectors, finding common solutions across the EU, will be key to safeguarding investors.

  Building NCAs' and ESMA's capacities
  New skills beyond their traditional areas of focus to understand and address the supervisory implications of new legislation and of novel market practices.

  Monitoring, assessing and analysing ESG markets and risks
  The objective is to identify emerging trends, risks and vulnerabilities that can have a high impact on investor protection and on financial market stability.

- **ESMA Strategy for 2023-2028:** details its long-term priorities and how it will use its tools to respond to future challenges and developments. There are 5 main elements, one of them:

  Enabling sustainable finance (hand in hand with Sustainable Finance Roadmap): effectiveness and integrity of ESG information, an improved ESG regulatory framework and supervision, and a recognition of the role of retail investors in financing the transition to a greener economy.

CHALLENGES

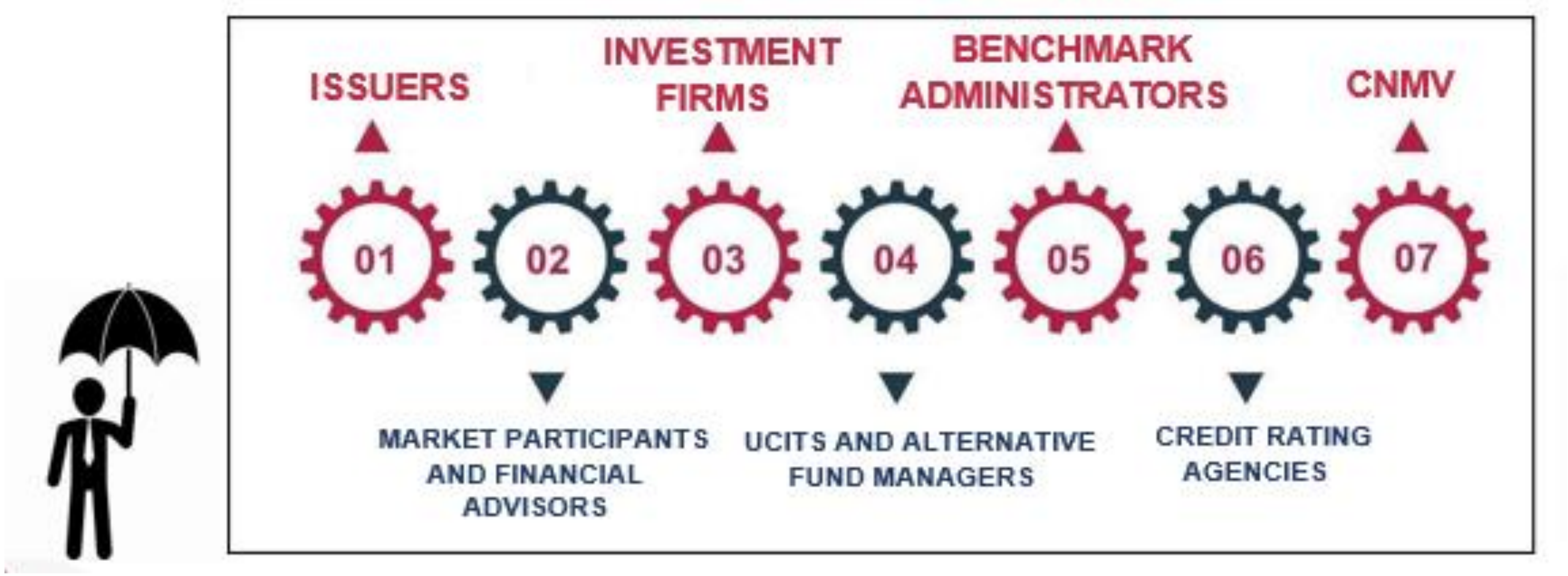
Challeges

Regulation

European regulations

Spanish regulations

Other guides



GENERAL REQUIREMENTS

General Requirements

Taxonomy

Taxonomy Regulation (2020/852)

Standardized criteria for determining whether an activity is environmentally sustainable, so that greater clarity is available on which activities are considered sustainable for making investment decisions (at the moment this regulation only regulates environmental criteria).

NO

- A rating of good or bad companies
- A must-have list where to invest or to develop financial products
- Make a judgment on the financial performance of an investment --(only refers to the
- environmental performance)
- Inflexible or static

YES

- A list of economic activities and relevant criteria related thereto
- A flexible list to suit different investment styles and strategies
- A list based on scientific knowledge and the experience of the sectors themselves
- A dynamic list, which will respond to changes in technology, science, new activities and data as they are published.

General Requirements

Taxonomy

WHAT

Environmental objectives (art. 9)

- ✓ climate change mitigation,
- ✓ climate change adaptation,
- ✓ sustainable use and protection of water and marine resources,
- ✓ transition to a circular economy,
- ✓ pollution prevention and control, or
- ✓ protection and restoration of biodiversity and ecosystems

General Requirements

Taxonomy

How is an activity considered environmentally sustainable?

1. Substantially contribute to at least **one of the six** environmental **objectives** defined in the Regulation.

2. **Do not significant harm (DNSH)** on the other environmental objectives.

3. Comply with **Minimum Social Safeguards**: perform minimum due diligence to avoid any violation of minimum social safeguards:

   - Labor policies and governance
   - Labor management systems
   - Key Performance Indicators (KPIs) to monitor health, safety, mobility, gender or gender pay gap
   - Auditing of sites or suppliers
   - Follow-up, disclosure and repair procedures

4. Comply with the **Technical Screening Criteria for sustainable economic activities.**

   - Compliance by standard/label
   - Automatic "eligibility" for best available techniques
   - Metrics with thresholds by intensity or relative reference

General Requirements

Taxonomy

WHO

- **Non-financial companies** (art. 8)

Disclosure of the proportion of eligible and non-eligible economic activities for climate change mitigation and adaptation objectives in their total turnover, capital expenditures (CapEx) and operating expenses (OpEx).

- **Financial companies** (art. 8)

Disclosure of the proportion of its exposures to eligible and non-eligible economic activities with respect to its total assets, as well as other types of exposures described in the regulations.

ISSUERS

Obligations for Issuers

SPANISH REGULATIONS

Law 5/2021, of April 12, 21, on the promotion of long-term shareholder engagement - More sustainable governance:

- Right to know the identity of investors.
- Certain transparency obligations for *proxy advisors*.
- A policy of institutional investor involvement.

Law 7/2021, of May 20, on climate change and energy transition

- Public procurement (art. 31)
- Evaluation of the financial impact of the risks associated with climate change generated by the exposure to climate change of its activity, including those of transition (art. 32).
- AMCESFI Report (art. 33)

Obligations for Issuers

EUROPEAN REGULATIONS

Corporate Sustainability Reporting Directive (CSRD) – Modification of NFRD

- The scope of application is extended to all large companies.
- Verification of published information by independent third parties.
- Digitization of information.
- Compliance with EFRAG standards.

Under negotiation

Sustainability Due Diligence Directive

- Subjective scope of application: certain EU companies by size and non-EU companies generating turnover in the EU.
- Obligation to have due diligence measures in the value chain.

European Green Bond Regulation

- Use of the funds collected for the exclusive financing of environmental economic activities or activities that contribute to the transition.
- Publication of annual allocation reports (verified by an independent third party).
- Maintenance on the website of all the information required by the Regulation during the life of the bond.

MARKET PARTICIPANTS AND FINANCIAL ADVISORS

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Obligations for Market Participants and Financial Advisors

SFDR

Regulation 2019/2088 on disclosure of information relating to sustainability in the financial services sector (Disclosure Regulation)

WHO

- **By entity type:** Financial market participants and financial advisors
- **By entity size:** Financial market participants with more than 500 employees
- **For having a sustainable product**

WHAT

First definition of financial products considered "sustainable" and establishes two different categories according to their degree of sustainability

NORMAL PRODUCTS

- ✓ How ESG risks are integrated + possible impact of ESG risks on product profitability.
- ✓ Disclaimer "*The underlying investments of this product do not take into account the EU criteria for environmentally sustainable economic activities*".

PRODUCTS E OR S CHARACTERISTICS (art 8)

- ✓ Promotes environmental or social characteristics (does not have a specific sustainable objective).

PRODUCT INVESTMENTS (art. 9)

- ✓ It has a specific sustainable objective.

Obligations for Market Participants and Financial Advisors

SFDR – Double materiallity impact on sustainability (art 3-7 SFDR)

INSIDE-OUT

Double materiality

OUTSIDE-IN

Impact OF investment decisions

Impact ON investment decisions

ON sustainability

OF sustainability

SFDR sustainability risk integration

Any environmental, social or governance event or condition that, if it were to occur, could have an actual or potential material adverse effect on the value of the investment

Product level information

Promotion of environmental or social characteristics

light green (article 8)

Objectives of environmental or social characteristics

dark green (article 9)

SFDR investor information

Product info (prospectus, IPP, web)

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Obligations for Market Participants and Financial Advisors

SFDR – Double materiallity impact on sustainability (art 3-7 SFDR)

Information on the web site

- **Policy for integrating sustainability risks** into the investment decision making/investment advisory process.
- **Due diligence policies in relation to the principal adverse impacts** on sustainability factors at the entity level, or lack thereof, and at the product level (market participants).
- **Consistency of the remuneration policy with the integration of sustainability risks** in its remuneration policy.
- **Description of the environmental or social characteristics of the sustainable investment objective.**
- Information on the methods used to assess, measure and monitor the environmental or social characteristics or impact of the sustainable investments selected for the financial product, including their sources of information, the selection criteria relating to the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall impact of the financial product in terms of sustainability.
- Information to be disclosed in pre-contractual information and periodic reports.

+

Precontractual information

- How sustainability risks are integrated into investment decisions/investment advice.
- Results of the assessment of the potential impact of sustainability risks on the profitability of the financial products they offer/advise on.
- For products promoting environmental or social characteristics, information on how the environmental or social characteristics promoted by the financial product are met.
- For sustainable products, the overall impact of the financial product in relation to sustainability through sustainability indicators.

+

Periodic information

- For products promoting environmental or social characteristics, degree to which the environmental or social characteristics have been met.
- For sustainable products, the overall impact of the financial product in relation to sustainability through sustainability indicators.

INVESTMENT FIRMS

Obligations for Investment Firms

Modification of MIFID II/ID: Sustainable preferences

Investment Firms must consider the "**sustainability preferences of investors**" (suitability tests): "Sustainability preferences" refers to a **client's decision** as **to whether any of the following types of financial instruments and insurance-based investment products (IBIPs) should be part of their investments**

A product for which the client determines that a minimum proportion should be invested in environmentally sustainable investments as defined by **taxonomy**

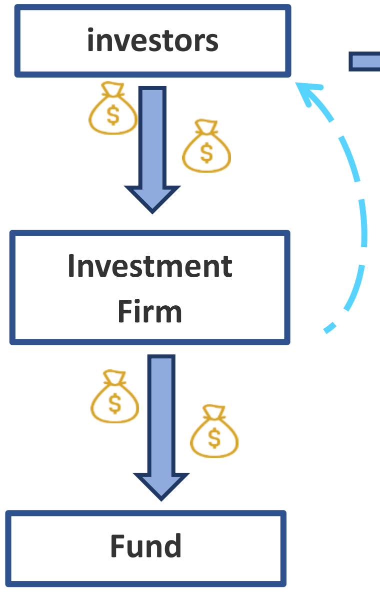
A product that takes into account **PIAS in sustainability factors**

A product for which the client determines that a minimum proportion should be invested in sustainable investments as defined by **SFDR**

In the event that the financial product does not meet any of these criteria, no product may be offered to the client as sustainable

Obligations for Investment Firms

Modification of MIFID II/ID: Sustainable preferences



1. Do you have sustainability preferences?

No → ESG financial instruments can be offered to the client, depending on their suitability test: investment objectives, financial situation and knowledge and experience in the financial markets

Yes

2. What % of your portfolio do you want to with sustainability preferences?

X %

3. What % of financial instruments do you want in that X%?

- 30 % — Sustainable investments according to Taxonomy
- 30 % — Sustainable investments according to SFDR
- 40 % — The product takes into account PAI

4. The investment Firm has that financial instrument?

No → Sustainability preferences should be adjusted until there is a product that can be offered to the client

Yes → Financial instrument can be bought according to suitability test and Sustainability preferences

Obligations for Investment Firms

Modification of MIFID II/ID: Sustainable preferences

- Integration of sustainability risks in **organizational requirements and risk management**
- Modification of **product governance policies and procedures**:
  - ✓ Requirement to consider sustainability in the definition of the product's target market and its distribution strategy.
  - ✓ Identification of the customer's circumstances, including their sustainability preferences, to verify that they are part of the product's target market.

Financial Advice

- ✓ The client will be informed, where appropriate, of the sustainability factors taken into account when selecting financial instruments.
- ✓ The investment proposal will include a summary of the advice provided and how the recommendation takes into account the client's sustainability preferences.

Product governance

- ✓ Potential target market for each product.
- ✓ Product sustainability factors shall be presented in a transparent manner and manufacturers shall provide distributors with adequate information about them.
- ✓ Product distribution should take into account, among other things, the customer's sustainability objectives.

Other requirements

- ✓ Establish, implement and maintain risk management policies and procedures
- ✓ The types of conflicts of interest will be identified

BENCHMARKS

Benchmarks

Regulation (EU) 2019/2089 **on climate benchmarks** establishes two categories of climate benchmarks: climate transition benchmarks and benchmarks for companies aligned with the objectives of the Paris Agreement.

- **Climate transition benchmark:** composed of selections of companies following a decarbonization pathway (the pathway will be quantifiable, scientific and time-bound).
- **Paris Agreement-adjusted benchmark:** composed of selections of companies whose carbon emissions present a general alignment with the long-term global warming goals of the Paris Agreement.
- **Rest of indexes**

- **They shall disclose information on:**
- -How ESG factors are taken into account in its investment strategy and how the methodology used is aligned with the carbon emissions reduction target (including source of information)
- -Where applicable, expressly state that they do not pursue ESG objectives

- **They shall disclose information on the index composition and calculation methodology**

DATES

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Dates

APPROVED REGULATION

Level 1	Disclosure Regulation Regulation (EU) 2019/2088 Applicable from 10/03/2021	Taxonomy Regulation Regulation (EU) 2020/852 Application 01/01/2022 and 01/01/2023)	MIFID II	UCITS	AIFMD	Climate Transition Index Regulation - BMR Regulation 2019/2089 Applicable from 30/04/2020
Level 2	Delegated Regulation Disclosure Regulation Delegated Regulation (EU) 2022/1288 Implementation 01/01/2023	Climate Delegated Act Delegated Regulation (EU) 2021/2139 Implementation 01/01/2022	MIFID II Delegated Act Sustainability Preferences Delegated Regulation (EU) 2021/1253 Implementation 02/08/2022	UCITS Delegated Act Delegated Regulation (EU) 2021/1270 Implementation 01/08/2022	AIFMD Delegated Act Delegated Regulation (EU) 2021/1255 Implementation 01/08/2022	BMR Delegated Regulation Delegated Regulation (EU) 2019/2089 Application from 23/12/2020
		Supplementary Delegated Act Delegated Regulation (EU) 2022/1214 Implementation 01/01/2022	MIFID II Delegated Act Governance - Delegated Regulation (EU) 2021/1269 Implementation 11/22/2022			Delegated Regulation (EU) 2020/1817 Implementation 12/23/2020
		Delegated Act art 8 Delegated Regulation (EU) 2021/2178 Implementation 01/01/2022				Delegated Regulation (EU) 2020/1817 Implementation 12/23/2020

RECENTLY APPROVED

Corporate Sustainability Disclosure Directive (CSDR)

PENDING APPROVAL

European Green Bond Regulation
Sustainability Due Diligence Directive

CNMV

CNMV

Strategic Lines – 2021-2022

Enhancing the role of the stock market in the transition to a more sustainable and inclusive economy

- **Monitoring participants' implementation of new European sustainability regulations**
- **Promotion of a sustainable finance regulatory framework based on the clarity and reliability of the information published by issuers**
- **Integration and monitoring of climate risk in its prudential, conduct of business and macroprudential supervisory functions**
- **Strengthening financial education for retail investors, including aspects related to sustainable finance**

CNMV

Strategic Lines – 2023-2024

Revitalizing capital markets to support growth and the transition to a sustainable economy

Emphasis on disclosure to investors of standardized and comparable information that is understandable and proportionate

Open and fluid dialogue in relation to the application of the new regulations

Strengthening the supervision of non-financial information, especially in terms of sustainability, by listed companies

Monitoring of possible greenwashing practices, as well as its prevention by providing guidance and criteria to the market and establishing clear supervision expectations

CNMV

Business Plan 2023

Review of compliance with the regulations on sustainability preferences

Participation in the design and implementation of the ESMA Joint Supervisory Action on sustainability in UCITS and AIF

Complementary actions in the field of sustainable finance emphasising the risk of greenwashing

Promote dialogue in the area of sustainable finance

Monitoring and ongoing dialogue with the industry regarding disclosures relating to taxonomy information of listed entities

Annex: Definitions

ESG investment criteria:

- **E (environmental):** beneficial activities to the environment (as water purification technologies or renewable energies), or reduction or mitigation of negative externalities on an entity's environment (as internal control systems for energy use or reduction of carbon emissions).
- **S (social):** entity impact on workers, consumers and communities in which it operates or are affected by its operations. Social criteria seek, among other objectives, to reduce discrimination and inequality through good business practices and the inclusion of the most disadvantaged groups in their decision-making and due diligence duties.
- **G (governance):** issues of corporate governance of the company and its corporate culture. Examples of good governance are accountability, the independence and composition of the governing bodies, the remuneration of its executives, the gender pay gap, lobbying practices, the fight against corruption, or transparency and fiscal responsibility.

Greenwashing: refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met.

Sustainability Risk. Any environmental, social or governance event or condition that, if it were to occur, could have a significant impact on the company's performance.

Annex: Definitions

Transition to a sustainable economy. Refers to the processes of changing the current economic model to achieve carbon neutrality by 2050 at the latest, as well as other long-term objectives. In this transition, in order to achieve more sustainable and inclusive growth, the securities markets have an important role to play. Companies, issuers and investors can use the EU taxonomy to decarbonize and green their activities and portfolios. The carbon neutrality to which Europe has committed itself means that all economic activities must achieve net zero emissions by 2050.

Climate change mitigation. The process of keeping the increase in global average temperature well below 2°C above pre-industrial levels and continuing efforts to limit this increase to 1.5°C, as set out in the Paris Agreement.

Sustainable finance. Their purpose is to incorporate environmental, social and good governance elements into business management and investment decision-making.

Sustainable investments. Investments in economic activities that contribute to an environmental or social objective; provided that the investments do not significantly harm either of these objectives and the beneficiary companies follow good governance practices.

Green and social bonds: public or private debt issued in the medium and long term to finance projects that have one or more environmental objectives or that finance social activities.

Annex: Definitions

Sustainability preferences. In the suitability test, entities offering investment services ask questions to profile the client based on their knowledge, financial situation and investment objectives. As of August 2, 2022, entities will ask a series of questions to collect the sustainability preferences of their clients, relating to the minimum proportion of sustainable investment or performance of environmental, social or good governance criteria. Investors can also decide in which type of investments (activities or practices) they do not want to invest or what their tolerance levels are through the principal adverse impacts (PIAs) on sustainability factors.

Principal Adverse Impact (PIAs). These are the negative impacts of investment advice and decisions on the different sustainability factors (ESG). Through the use of a series of indicators, some mandatory and some voluntary, entities aim to capture the negative impact of investments on the environment and society (e.g., human rights violations or exposure to fossil fuels will be measured). The PIAs include indicators on specific activities such as the production of controversial weapons and impact indicators such as carbon emissions. It will be up to financial market participants to report sustainability PIAs to the client (or, if they do not take adverse impacts into account, they will have to include a clear justification as to why they do not do so).

ESG rating. Assessment of environmental, social and governance factors in financial instruments and companies. These ratings can be used by investors to take into account risks and opportunities related to ESG issues. Currently, ESG ratings are not regulated, so the quality of their ratings or the different methodologies used does not follow established guidelines.

THANK YOU