



Faculty of Law, Economics and
Finance of the University of
Luxembourg

REGULATING SUSTAINABLE FINANCE IN THE DARK
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UNIVERSITÉ DU
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**ZETZSCHE & ANKER-SØRENSEN, *REGULATING SUSTAINABLE
FINANCE IN THE DARK*, [WWW.SSRN.COM/ABSTRACT=3871677](http://www.ssrn.com/abstract=3871677)**



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HSGM.Uni.Lu - Research Domains

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1.

**BUSINESS &
HUMAN RIGHTS**

2.

**DEVELOPMENT
ECONOMICS &
DEVELOPMENT
FINANCE**

3.

**FINANCIAL
INCLUSION**

4.

**FINANCING THE
FIGHT AGAINST
CLIMATE CHANGE**

5.

**CLEAN ENERGY &
CLIMATE-NEUTRAL
ECONOMY**

6.

**GENDER,
INEQUALITY
AND CONFLICTS**

7.

**GREEN
SUPPLY CHAINS**

8.

**GREEN
ACCOUNTING**

9.

MIGRATION

10.

**RULE OF LAW
& DEVELOPMENT
COOPERATION**

11.

**SUSTAINABLE
GOVERNANCE
STRUCTURES
IN EUROPE**

12.

**SUSTAINABLE
FINANCE**

Topic of Today

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- Analysis of EU SF Strategy, Green Deal and Implementation
- Focus on Asset Managers and Asset Owners (not banks)
- Develop recommendations on how to best regulate SF in light of present data and constraints

Table of content

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I. Introduction

II. SFAP of 2018: A Nudging Approach

III. Sustainable Finance Strategy 2021: What is to come?

IV. The State of Ignorance

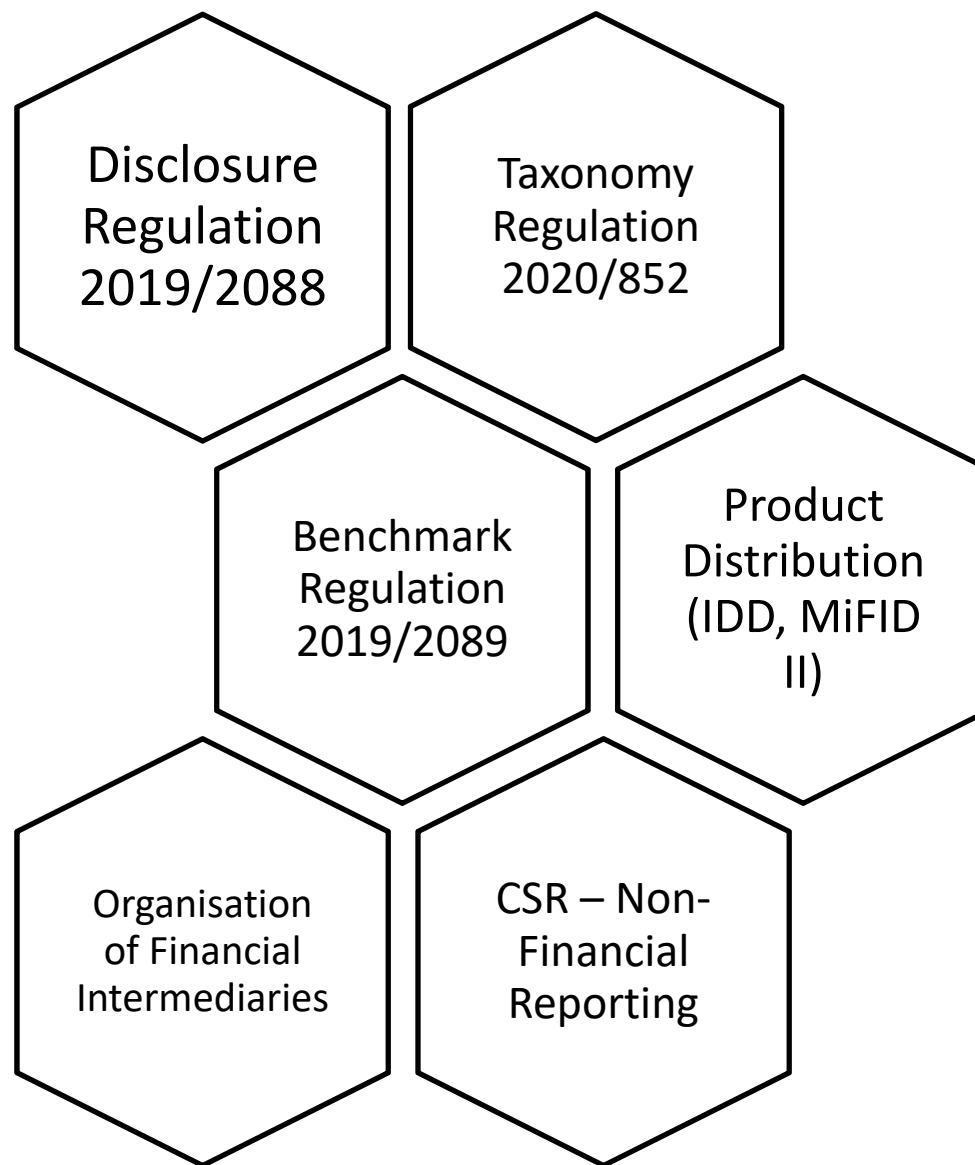
V. Principles for Regulating in the Dark

Conclusion

I. SFAP 2018

SFAP 2018 – six core initiatives

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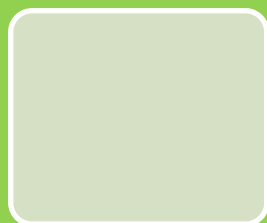


Tackling the issues

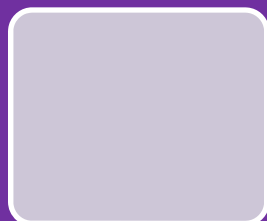
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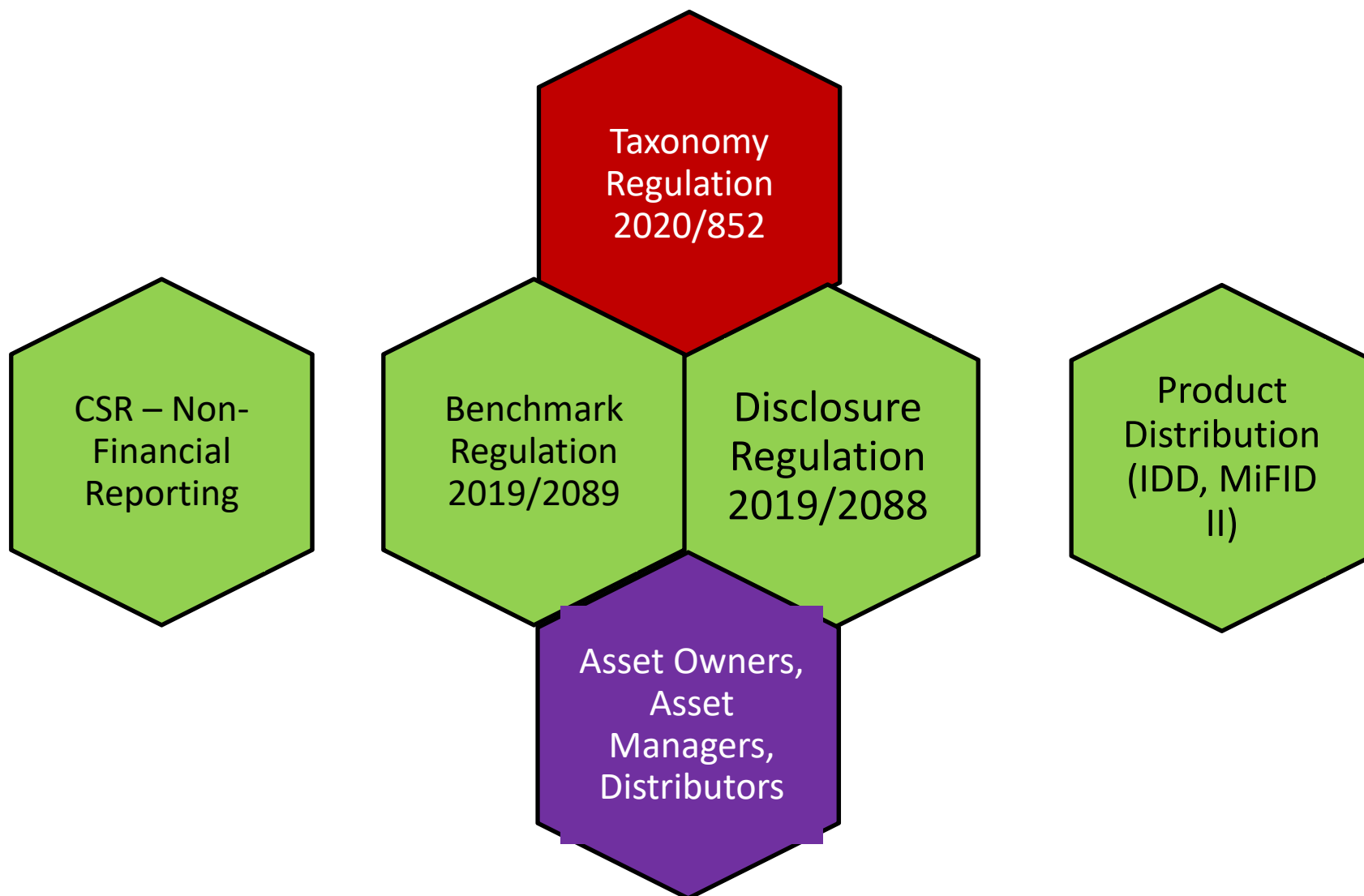
What is sustainable? (terminology)



Who is sustainable?



Acting sustainably



Sustainability as defined by the European Commission (Art 3 of the EU Sustainability Taxonomy Regulation)

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Substantial contribution to one environmental objectives (e. carbon neutrality, biodiversity etc. - all defined by the Taxonomy Regulation)



Economics

Does not significant harm (DNSH) to other environmental objectives



Law

Compliance with Minimum Legal Safeguards (Art. 18 Taxonomy Regulation)

OECD Guidelines for
Multinational Enterprises
(supply chain, liability etc.)

UN Principles for
Business and Human
Rights

UN&ILO Minimum Labour
Laws, work safety, Social
Insurance

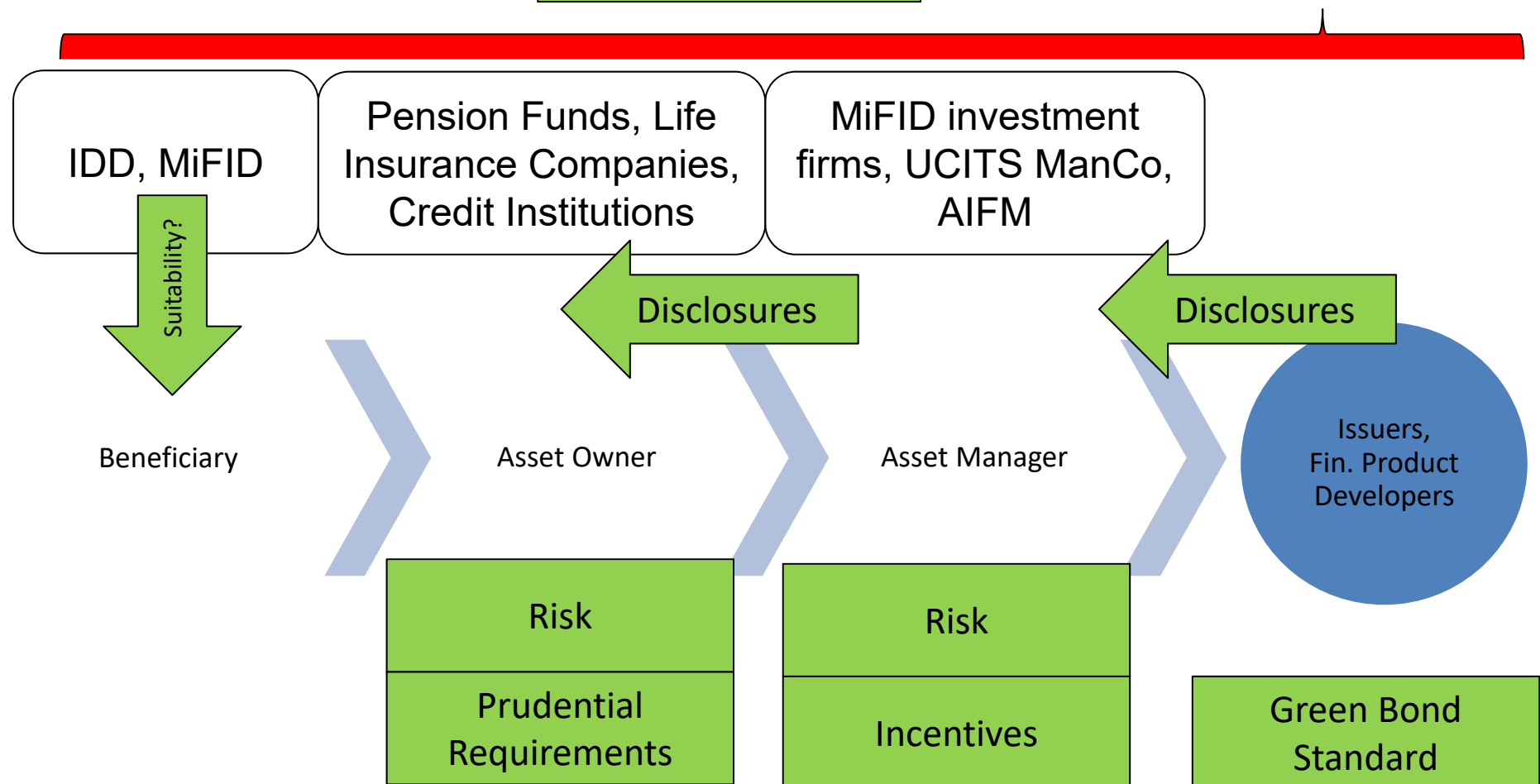
Disclosure Requirements across the FS Value Chain

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Benchmarks

Taxonomy



Potential Impact of SFAP

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- Clarifying terminology
- Ensuring comparability
- Rendering sustainable finance the new normal
- Questions marks on organization (to be continued)

⇒ *Nudging* towards sustainability

⇒ Not: mandating sustainability

Organizational Requirements

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- Distribution: integrate ESG into « suitability test » on behalf of clients
- Organisation: remuneration?
- Operations: consider ESG risks in daily operations; adjust fiduciary duties (not: always invest sustainable!)
- Risk Management: Consider (very) long-term impact
- « Suitability » for distribution, investments?



Asset Owners,
Asset
Managers,
Distributors

The diagram consists of a purple hexagon on the left containing the text 'Asset Owners, Asset Managers, Distributors' and a blue rounded rectangle on the right containing the text 'not implemented'.

not implemented

II. SF Strategy 2021: What is to come?

The EU's New Green Deal

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- (even) more capital
- Public-private partnerships
- Additional EU programmes
- From high to super-high on the agenda
- Enhanced speed
- New Sustainable Finance Agenda – consultation March 2020 onwards

- KPMG report more or less silent on SF
- COM AIFMD II review: considering renewed SF agenda
- **AIFMR Regulatory Reporting template (62.1):**
If more detailed portfolio reporting? more details on sustainability-related information, e.g. **risk exposure and/or impacts**? E.g. sustainability-related data, in particular on **exposure to climate and environmental risks**, including physical and transition risks (e.g. shares of assets for which sustainability risks are assessed; types and magnitudes of risks; forward-looking, scenario-based data)

- Full section on ESG/ sustainability (p. 77 et seq.)
 - Question 94. The EU Taxonomy Regulation 2020/852 provides a framework for identifying economic activities that are in fact sustainable in order to establish a common understanding for market participants and prevent green-washing. To qualify as sustainable, an activity needs to make a substantial contribution to one of six environmental objectives, do no significant harm to any of the other five, and meet certain social minimum standards. **In your view, should the EU Taxonomy play a role when AIFMs are making investment decisions, in particular regarding sustainability factors?**
 - Question 95. Should other sustainability-related requirements or international principles beyond those laid down in Regulation (EU) 2020/852 be considered by AIFMs **when making investment decisions?**

⇒ From nudging to mandatory?

- Implementing the Taxonomy: L2 on climate etc. => green
- How to treat „non-Taxonomy-Green investments?“ Transition technologies?
- CSR Disclosure Directive: expand scope, streamline details, enhance certainty, cover SMEs
- ***adapting rules on fiduciary duties, best interests of investors/the prudent person rule, risk management and internal structures and processes in sectorial rules to directly require them to consider and integrate adverse impacts of investment decisions on sustainability (negative externalities)***

⇒ From nudging to mandatory?

Renewed SF Agenda (July 2021)

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2018: THE FOUNDATIONS OF THE EU SUSTAINABLE FINANCE FRAMEWORK

1. EU TAXONOMY



A common classification of economic activities substantially contributing to environmental objectives, using science-based criteria.

- Taxonomy Regulation: **adopted** on 18 June 2020

2. DISCLOSURES



Comprehensive disclosure regime for both non-financial and financial institutions to provide investors with the information necessary to make sustainable investment choices.

- Sustainable Finance Disclosure Regulation (SFDR) **applies** since March 2021
- Corporate Sustainability Reporting Directive (CSRD) **proposed** by the Commission in April 2021
- Sustainability preferences: **adopted** by the Commission in April 2021

3. TOOLS



Broad toolbox for companies, market participants and financial intermediaries to develop sustainable investment solutions, while preventing green washing.

- EU Climate Benchmarks Regulation **applies** since April 2020
- Standard for European green bonds (EuGB), **proposed** by the Commission today

Renewed SF Agenda (July 2021)

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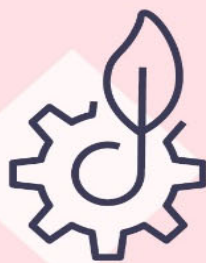
FINANCING THE TRANSITION TO SUSTAINABILITY

This strategy provides the tools and policies to enable economic actors across the economy to finance their transition plans and to reach climate and broader environmental goals, whatever their starting point.



INCLUSIVENESS

This strategy caters for the needs of, and provides opportunities to individuals and small and medium companies to have greater access to sustainable finance.



FINANCIAL SECTOR RESILIENCE AND CONTRIBUTION

This strategy sets out how the financial sector itself can contribute to meet Green Deal targets, while also becoming more resilient and combatting greenwashing.



GLOBAL AMBITION

This strategy sets out how to promote an international consensus for an ambitious global sustainable finance agenda.



Renewed SF Agenda (July 2021)

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- Reflecting sustainability risks in reporting standards, accounting
- Improving transparency of credit ratings and rating outlooks
- *Identifying and managing sustainability risks by banks and insurers (CRD/CRR, Solvency II)*
- *Managing sustainability risks at system level*

Accelerating the contribution of FS to transition efforts

- *Improving science-based target setting, disclosure and monitoring of the financial sector's commitments*
- *Clarifying the fiduciary duties and stewardship rules of investors to reflect the financial sector's contribution to Green Deal targets*
- improving availability, integrity, transparency of ESG research, ratings
- Addressing greenwashing
- *Monitoring transition*

⇒ From nudging to mandatory?

IV. The State of Ignorance

IV. State of Ignorance

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- Lack of Experts' Consensus
 - Lack of Certain Data Sustainability – Finance
 - Lack of Consistent Application
- ⇒ As of now Zero data on Taxonomy, Benchmark results
- ⇒ Regulators regulate in the Dark

1. Lack of Expert Consensus

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- No widely acceptable models on key issues (eg « greenium »)
- Huge variety in results

⇒ Further work necessary

2. DATA

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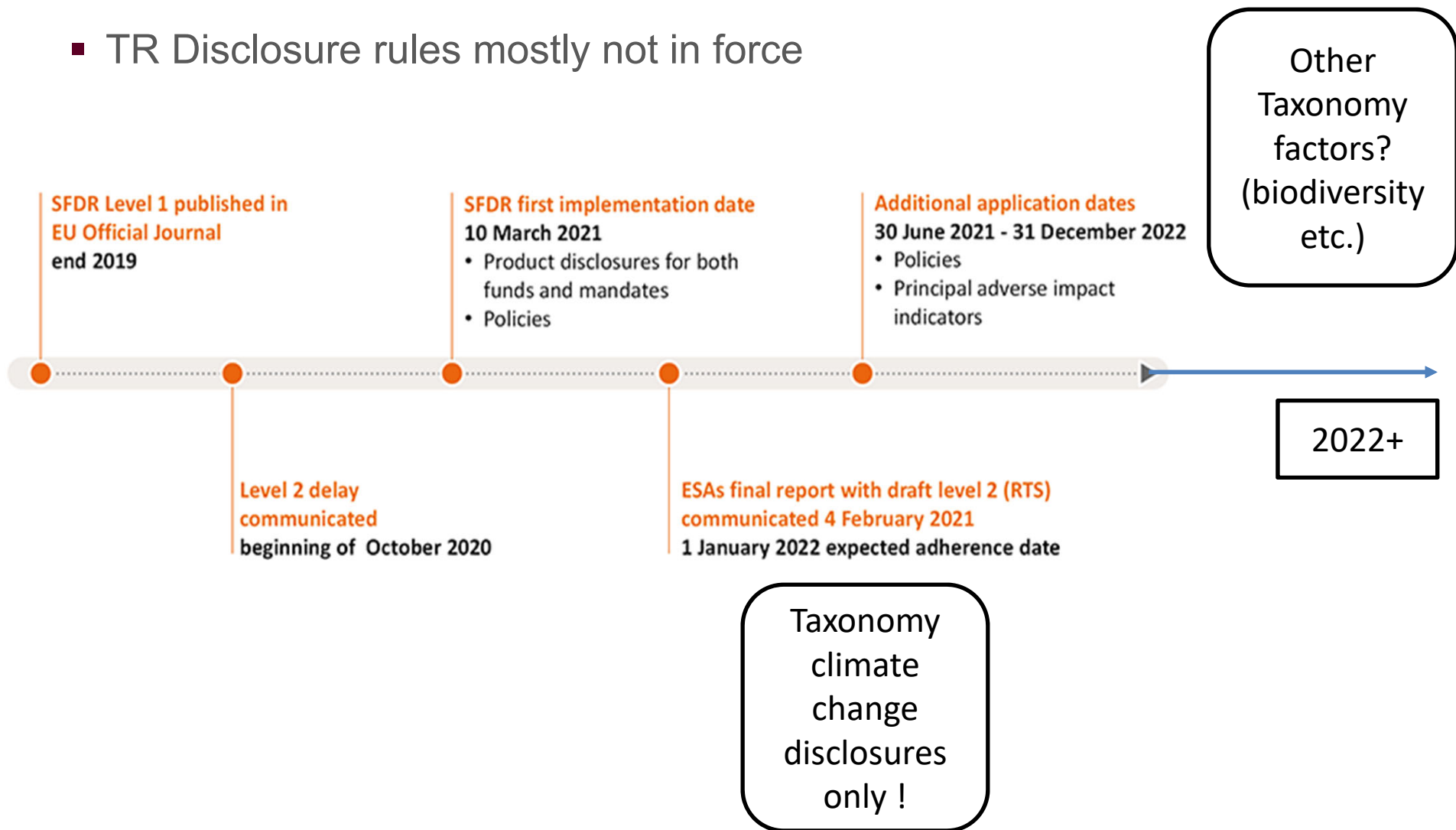
- Right now we do not know how sustainability impacts on profitability
 - Frankfurt School UCITS study (2020): 28 out of 101 « green » UCITS did not disclose sufficient data; cash flows of the remainder often currently not uniformly classified by taxonomy
- ⇒ Not even speak about traditional UCITS
 - ⇒ Further work necessary
 - ⇒ Standing the test of reality
 - ⇒ Data collection rapidly increasing, yet: analysis, valuation takes time!

2. DATA

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- TR Disclosure rules mostly not in force



Main takeaways from 10+ ESMA statements

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- General concerns about the lack of a “clear and appropriate taxonomy and labels” on ESG terms **at the time investment firms, institutional investors and assets managers are requested to disclose** how they integrate sustainability risks in the investment decision-making process or advisory process
- **importance of proportionality** to allow a smooth sustainability transition to smaller firms
- Adoption of a **principle-based approach**.

⇒ A message of caution

Main takeaways from 10+ ESMA statements

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- Data is key => **single EU data platform covering both financial and ESG information**
- Sound risk management
- Ensure investors and consumers have access to SF products safely and transparently
- Supervisory convergence

3. Inconsistent Application

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- Complex legislation adopted in 2019 and 2020
 - Too much, too fast
 - What it takes:
 - (1) integration of new standards in IFRS, GAAP,
 - (2) **reporting entities** expertise, software tools
 - (3) **information intermediaries** (including benchmark providers) expertise, scoring methodology, software tools
 - (4) **Financial intermediaries** expertise for investment decisions, risk management, software tools
 - (5) **supervisors** expertise for supervisory guidelines, develop and implement data-driven supervisory tools, hire qualified and skilled staff for rigid enforcement
- ⇒ Development of best practices take time, experimentation, experience

4. Regulatory Risks of the Dark

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- Investor protection
 - The unfulfilled promise of the Greenium?
 - Harming the „Green-biased folks“?
 - Systemic Risk
 - Large-scale capital misallocation
 - Sustainability Risk
 - Delaying the sustainability transformation
 - Undermining societal report
- ⇒ Avoid unwanted effects of premature regulation
- Regulators to apply humility

V. Principles for Regulating in the Dark

1. Sustainable Intermediary Set-up

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a) Fitness & Properness

(-) Sustainability Officer (like in UK Senior Managers Regime), since sustainability is **the new normal** and impacts on all sectors

(+) Firm-wide coaching and training

b) Governance

(-) perceived short-termism addressed through SRD II and EU environmental and supply chain legislation in the making;
wait for analysis => 5 years

c) Remuneration

(-) Too complex for regulating in the Dark; analysis => 5 years

⇒ **Enhance «test-and-learn» rather than mandatory rules**

2. Sustainable Operating Business

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- a) Investment and risk policies depend on data and model progress
 - b) Transformation to create model risk (« transition risk »)
- ⇒ **Enhance «test-and-learn» rather than mandatory rules**

3. Sustainability-oriented Prudential Requirements?

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- Prudential requirements extremely difficult to write and apply
 - ⇒ Lack of sustainability-oriented data
 - ⇒ Avoid detailed CRR style rules across the FS sector
 - «Tragedy of the Horizon» [Carney, 2015]
 - ⇒ Costs today, benefits accrued to future generations
 - «Tragedy of Uncertainty»
 - ⇒ Uncertainty as to whether adopted regulation results in benefits; while costs are certain, and if so which regulation works.
 - ⇒ Macro vs Micro Perspective
- ⇒ **Enhance «test-and-learn» rather than mandatory rules**

3. Sustainability-oriented Prudential Requirements?

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- **Risk-based approach:** institute-specific analysis =>
eg. CRR Pillar 2/3 based on Own Risk Assessments [ICAAP – Internal Capital Adequacy Assessment Process]
 - Suitable for **certain** institutes
 - May work better if Taxonomy works
 - ⇒ Learning curve re risk modelling, data reliability etc.
- ⇒ **Enhance «test-and-learn» rather than mandatory rules**

4. The right regulatory order

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- 1) Implement taxonomy across sectors
- 2) Ensure reporting based on taxonomy
- 3) Collect data (and ensure data platforms, comparability etc.)
- 4) Assess data with some representative time series
- 5) Draft rules & standards on the organization of intermediaries
- 6) Review whether shift from nudging to mandatory > costs.

5. How to regulate SF in the Dark?

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- Building expertise
- Consistent application of multiple adopted rules (guidelines, communication, enforcement) rather than issuing new rules
- Retain openness to innovation: Sandboxes, Waivers, Innovation Hubs
=> Look at FinTech & RegTech sector

5. How to regulate SF in the Dark?

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- Regulatory instruments?
 - ⇒ Code-style / comply or explain approaches
 - ⇒ Emphasis on risk modelling, test-and-learn approaches (« Sandbox »)
 - ⇒ open standards > rules

- «Test-and-learn»
 - ⇒ Investors, intermediaries, regulators to experiment and learn
 - ⇒ FinTech-style Sandbox / innovation Hub Approach to SF disclosures, risk, governance and remuneration models,

Conclusion & Thesis

Conclusion

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- Sustainable Finance is of paramount importance.
- Taxonomy and SFAP 2018: comparability, disclosure. Good.
- Nudging approach of SFAP I ambitious, not yet absorbed.
- Current state; lack of data, consensus, inconsistent application

- **From nudging to mandatory?** Potential domino effect – more and more legislation builds now on the taxonomy: IFRS, NFRS EFRAG guidelines etc. High risk regulatory strategy

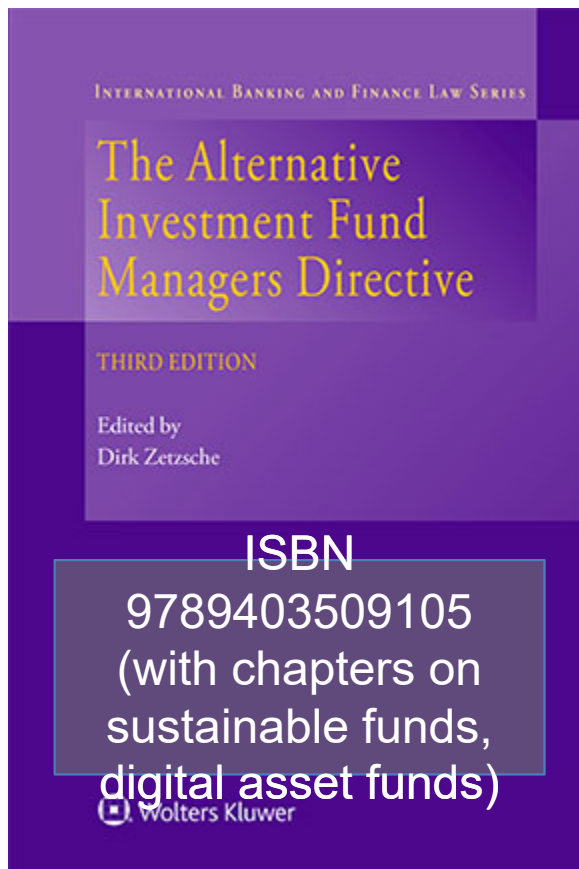
- **Mitigate risk of regulatory failure** (avoid « one size fits all »)
 - ⇒ Intermediary-specific risk approaches
 - ⇒ «wait and see» : highly successful in FinTech sector (China!)
 - ⇒ «Test-and-learn» : « Sustainability Sandbox »

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Thank you!



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