Sustainable financial markets: translating changing risks and investor preferences into regulatory action

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Introduction

I would like to thank IDA Ireland and the Financial Times for inviting me to this year’s European Financial Forum to share my views on how to promote investor protection and secure financial stability in the face of climate change and financial markets that need to respond.

The climate crisis and its impact on financial markets

Scientists\(^1\) tell us that, if global warming continues at the current rate, temperature increases are likely to reach 1.5°C between 2030 and 2050 and, on average, rise to 3°C by the end of this century. Risks for mankind associated with global warming at or above 1.5°C are already severe, but not as severe compared to a 3°C average increase scenario. The question therefore is not whether climate change is happening, but how severe it will be. Coming from the Netherlands, a low-lying country with significant exposure to the risk of flooding\(^2\), this is not just a theoretical exercise.

It is not only the environment which is at stake. Global warming and the associated change in the climate may also trigger severe social and economic knock-on effects, especially for the most vulnerable parts of society. In particular, the economy is impacted by the consequences of climate change through both the *physical risks* arising from events associated with climate change, as well as *transition risks* relating to the short and long-term effects of the adjustment

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to a new economic system which is capable of adequately responding to climate change risks and costs.

To use mainstream economic theory, we can say that we are confronted with the typical problem of addressing negative externalities associated with the use, or misuse, of natural resources. However, we must also acknowledge that the scale of the problem is of such magnitude that we should prepare for a more significant shift in thinking.

To address this complex situation, in 2018 the European Commission issued its strategic long-term vision for a climate-neutral economy by 2050 which set the stage for the new Commission’s plan for a European Green Deal that was launched last December. Also, last November the European Parliament declared a climate and environmental emergency, calling for immediate and ambitious action to limit global warming to 1.5°C relative to pre-industrial levels.

While political action is needed to set priorities and the appropriate fiscal policies and incentives, including an adequate carbon pricing mechanism, the financial sector plays a pivotal role as a key transmission channel of the much-needed transformation of our economy.

To give the sense of how rapidly such transformation needs to take place, the public debate has recently focused on the evocative and alarming expression ‘Our house is on fire’ which encapsulates the idea that climate change is regarded as the number one risk for the global economy.

A fire which will be impossible to contain without the contribution of the financial sector, to help channel investments towards the areas, which can help efforts to address the climate crisis.

At the same time, we need to be aware that this fire might also extend from other sectors of the economy to the financial sector through direct and indirect channels: for example, through losses from climate-related risks arising from abrupt price impairments or the reduced value of collaterals, via a lower pace of economic growth and tighter financial conditions. In other

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5 https://www.weforum.org/agenda/2020/01/greta-speech-our-house-is-still-on-fire-davos-2020/
words, climate and environmental risks constitute a key source of potential financial instability⁸.

For securities regulators this is a high priority. While it is not our role to intervene in the political and technical debate of what constitutes a green investment, we have a clear mandate to prevent threats to financial stability and ensure investor protection. This mandate is very relevant for the adjustment of financial markets to the risks arising from climate change, and the associated transition to sustainability.

The financial markets are at a point of change, as investor preferences shift towards financial products that incorporate Environmental, Social and Governance (ESG) factors. These factors, in turn, are increasingly affecting the risks, returns and value of investments.

For a long time, the private sector has been at the forefront of developments in this area and should be commended for that. However, it is now important that the public sector steps in. Key pillars supporting the shift towards a more sustainable financial system are the measurement, verification and disclosure of ESG factors.

Reliable and relevant information on ESG factors is needed to respond to changing investor preferences, but also to ensure that these factors are taken into account when assessing the risks, returns and value of investments.

To increase the credibility of the related standards and oversight, it is necessary that they sit with public authorities. The role of the public sector should not be confined to rule-making at political level, but it must also respond to the need for rigorous European and international standards and credible supervision by public authorities.

In this respect, ESMA’s commitment to support sustainable finance is reflected in the new, and reinforced, mandate to incorporate sustainability considerations into our activities, as highlighted in our recent Strategy on Sustainable Finance⁹.

This is why today I would like to share some recommendations on two specific areas where we believe it is necessary to have a stronger role for the public sector: the provision of rigorous and standardised ESG information and specific measures to prevent the risk of greenwashing.

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⁸ https://www.ngfs.net/sites/default/files/medias/documents/ngfs_first_comprehensive_report_-_17042019_0.pdf
Rigorous and standardised ESG information

Given the increasing demand to mainstream sustainability within financial markets, I would like to reiterate the importance of high-quality information on the impacts that ESG factors have on financial markets participants and companies and vice-versa.

Financial firms, in particular, need to be transparent on the ESG profile of the investments they make on behalf of their clients. ESMA is conducting regulatory efforts to codify – together with EIOPA and EBA – what is required when these firms market products claiming to have ESG characteristics and on how to account for the adverse impacts of their investments.

The introduction in European law of the requirement for financial firms to disclose principal adverse impacts of their investment decisions on the environment is a ground-breaking transparency initiative. We will launch a public consultation by the end of this quarter on the specific disclosure requirements and look forward to your feedback.

However, investment firms are only a part of the ESG disclosure spectrum. As ESG investing becomes more popular, we need to ensure that market participants are provided with reliable and comparable disclosure by companies, starting with large issuers.

For an efficient allocation of capital, it is essential that disclosure requirements are consistent across the whole investment chain, covering information from both investment firms and the companies they invest in. In this respect, while for investment firms we are moving towards disclosure standardisation, for corporate disclosures we are still far from reaching that objective.

ESMA has consistently called for better corporate ESG disclosures, most recently in our advice to the European Commission regarding measures to counter short-termism, published last December.

On the one hand, the co-existence of multiple disclosure standards and frameworks requires consolidation, to achieve, in the medium-term, a single set of standards which will also be the basis for digitalisation of ESG information. Given the global reach of the challenges posed by the transition to sustainability, Europe can play a leading role in promoting this consolidation at international level. It would not only be short-sighted but also detrimental for investors – who typically operate in global financial markets – to build a set of corporate ESG disclosure standards that is only regional.
The European Commission’s international platform on sustainable finance can help launch such a consolidation process and create the basis for European standards that are truly international. On the other hand, while we pursue this vision, there is also an immediate need in Europe for more specific rules for corporate disclosure principles, and requirements which could constitute a stop-gap measure to reduce the divergence in practice that we currently observe in the market. Such measures should take into account internationally recognised standards, to the extent possible, to pave the way for a more complete global harmonisation in the medium term and allow Europe to show leadership in this area.

Before I move on to speak about greenwashing, I want to say that ESMA is ready to support the EU institutions with the development of ESG standards across the whole investment chain, engaging with all relevant stakeholders as well as with our international colleagues. So, I look forward to continuing our efforts within IOSCO’s Sustainable Finance Network, and its contribution to the development and consolidation of ESG standards.

**Preventing the risk of greenwashing**

Finally, let me discuss briefly the more general problem of greenwashing. This refers to a wide variety of practices that range from mis-labelling to mis-representation and mis-selling of financial products. As the number of products that claim to be linked to the sustainability performance of firms increases, driven by market demand, we need to be careful to ensure that investors do not end up buying products which are marketed as sustainable when in reality they are not. Here, we should not be naïve. The many risks that can lead to misleading financial information are also valid in the case of non-financial information.

While improving the quality of ESG disclosures addresses part of the greenwashing problem, there are two other relevant issues that we need to address, i.e. green bonds and ESG ratings.

On green bonds, in order to avoid mis-selling or mis-labelling practices, we need to ensure that fit-for-purpose public standards and supervision underpin the market for these products. While private sector initiatives have so far driven the green bond market, a European standard set by public authorities would lend greater credibility and would help drive bond issuance onto a more sustainable path. Such standard would be particularly important given the strong demand for green securities from investors.

One of the key issues to address when developing a new European standard for green bonds is how to regulate and supervise third parties that certify ESG information. Here, I believe that
public authorities are needed to provide the strong registration and supervision required to prevent greenwashing.

In that context, I also want to mention ESG ratings, as they are becoming increasingly important but the level of public scrutiny and supervision of them, in my view, is far from optimal. The lack of clarity on the methodologies underpinning those scoring mechanisms and their diversity does not contribute to enabling investors to effectively compare investments which are marketed as sustainable, thus contributing to the risk of greenwashing.

Personally I believe that, where ESG ratings are used for investment purposes, ESG rating agencies should be regulated and supervised appropriately by public sector authorities.

**Conclusions**

Ladies and gentlemen, let me conclude.

The transition to sustainability requires rapid and concrete action by all actors involved in making the European economy more resilient vis-à-vis the challenges posed by climate change.

These challenges have global reach and therefore, while taking a leading role, Europe should promote, as much as possible, the adoption of standards, rules and practices that are internationally recognised and adoptable.

The public sector has a pivotal role to play in this transition. First and foremost, to protect investors at this critical juncture, but also to lend credibility to the efforts being made to facilitate this transition and to take advantage of the opportunities that it creates. In particular, it can do so by ensuring that public authorities are responsible for setting robust standards for rigorous ESG measurement disclosures, and for supervising the relevant actors and products to prevent the risk of greenwashing.

ESMA is committed to contribute to the shift towards a sustainable European financial system by supporting the necessary measures across the whole investment chain.

Thank you.