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Sustainable Finance: Integrating ESG Criteria into Investment Decisions

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1. What is *Sustainable Finance*?

- **Sustainable Finance** is *„the provision of finance taking into account environmental, social and governance considerations, leading to increased investments in longer-term and sustainable activities“* (European Commission)

- so-called **ESG criteria** are (to be) used in the risk management process of investment decision making to gauge related sustainability risks.

Environment	Social	Governance
› Formal environmental policy › Environmental management system › Programmes and targets to reduce GHG emissions › Programmes and targets to increase renewable energy use › Carbon intensity trend › % primary energy use from renewables › Environmental & social standards in credit and loan business › Sustainable financial services	› Policy on freedom of association › Formal policy on the elimination of discrimination › Programmes to increase workforce diversity › Employee turnover rate › Activities in sensitive countries › Employee incidents › Collective bargaining agreements	› Policy on bribery and corruption › Whistleblower programmes › Signatory to UN Principles for Responsible Investment › ESG reporting standards › Policy on money laundering › Disclosure of directors‘ remuneration › Board independence › In-house team dedicated to responsible investment/finance

(one) Example: KfW’s ESG criteria for non-governmental (bond) issuers

Source: https://www.kfw.de/nachhaltigkeit/KfW-Group/Sustainability/Sustainable-Banking-Operations/Sustainable-Investment/KfWs-Sustainable-Investment-Approach/Integration-of-ESG-Criteria/

2. What are key drivers for Sustainable Finance?

- **Public Policy Goals:** Paris Agreement *(Art. 2.1c)*, Sustainable Development Goals

… and associated investment gaps

- **Private sector business opportunities … and associated risks:**
  - Increased financing demand for low-carbon economy in new growth areas and sectors
  - New products (green loans / bonds, low-carbon indices, etc.)
  - New client segments
  - Renewed engagement with clients, employees and shareholders
  - Reputational advantages

TCFD TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

3. The current political momentum (1)

Recommendations of the High-level Expert Group on Sustainable Finance

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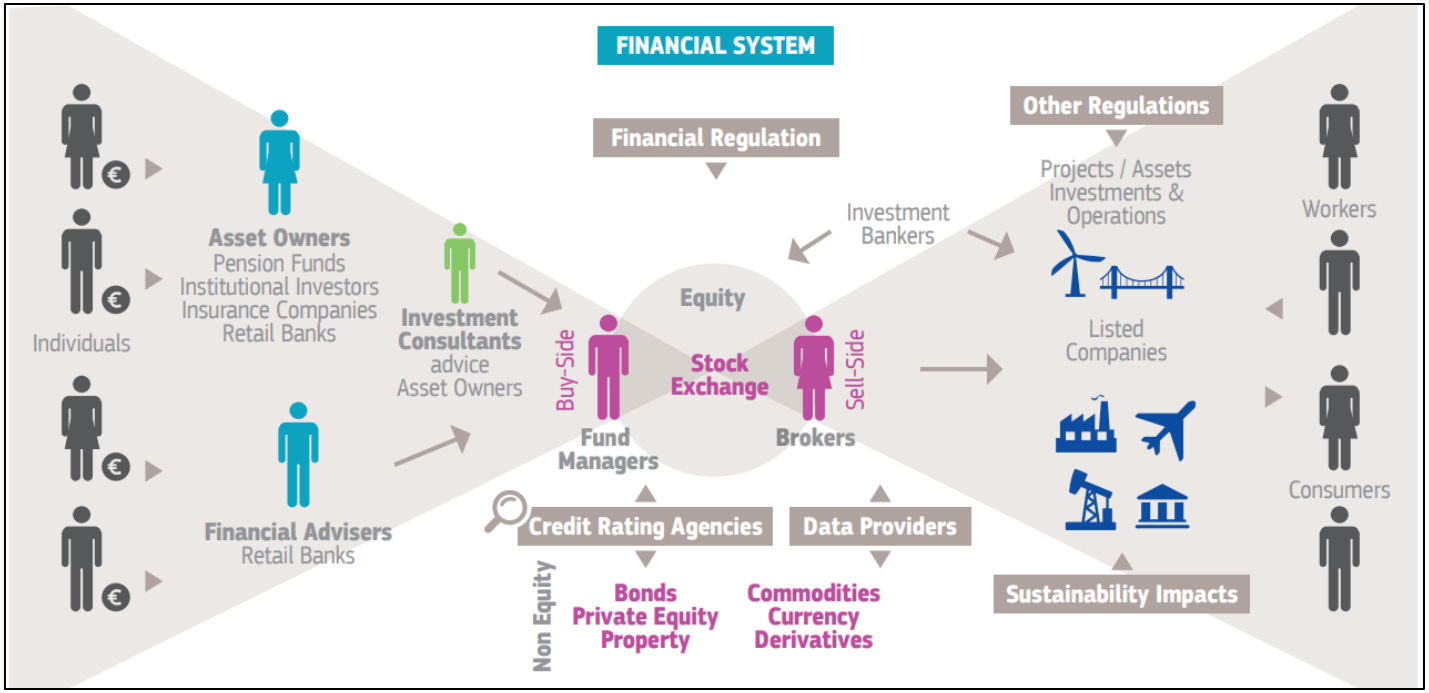
… on how to steer the flow of capital towards sustainable investments

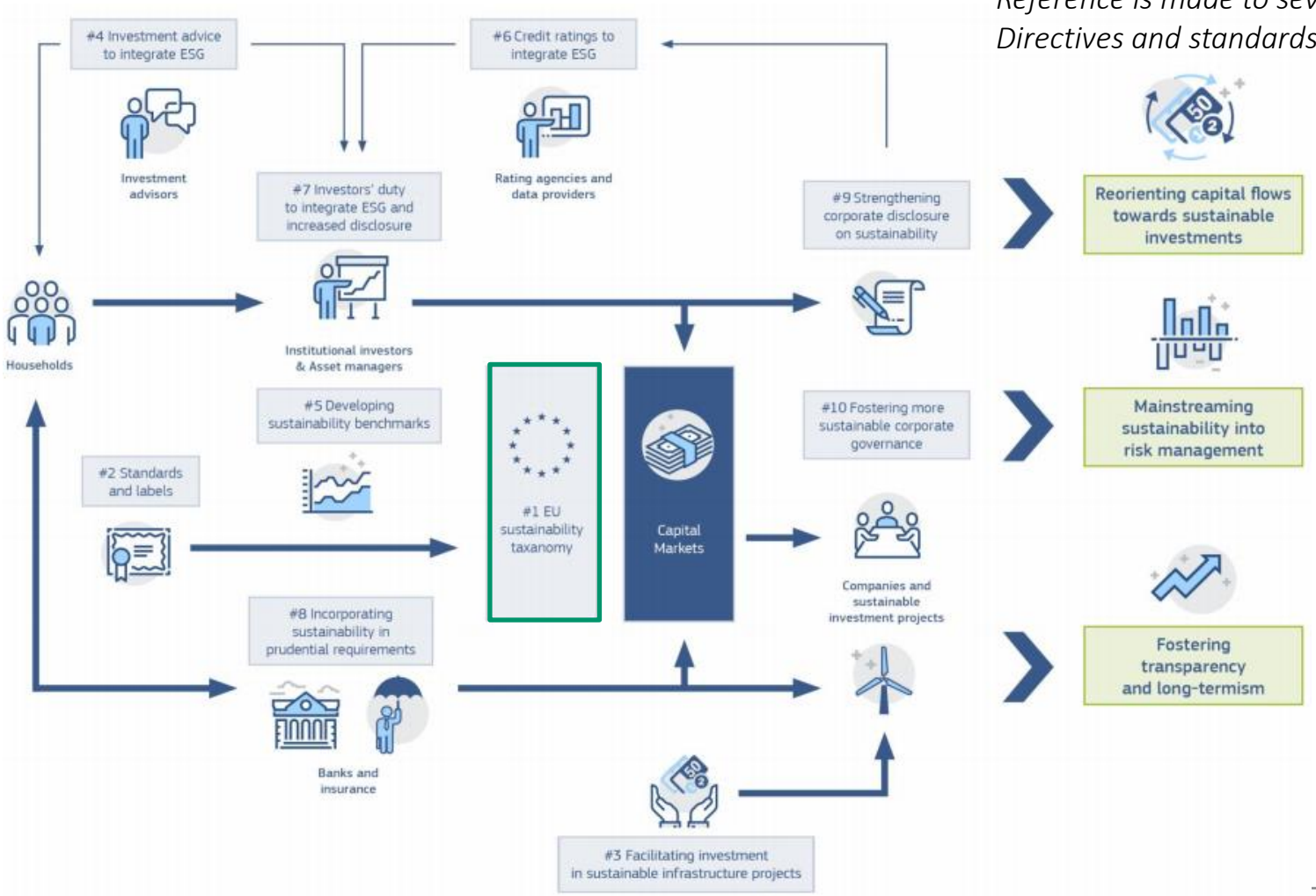
- 8 key recommendations as essential building blocks for further action
- 8 cross-cutting recommendations (incl. to combat short-termism)
- 8 recommendations on financial institutions and sectoral issues
- 4 social and broader environmental sustainability recommendations



Source: Aviva Investors, European Political Strategy Centre

3. The current political momentum (2)

The EU Action Plan: *A benchmark for Sustainable Finance Policies*



Reference is made to several Directives and standards:

- MiFID II
- IDD
- Solvency II
- IORP II
- UCITS
- AIFMD
- Capital R.R.
- NFI Directive
- IFRS
- etc.

Source: EU Action Plan on Sustainable Finance (3.2018)

4. The No. 1 priority Action: a Sustainability Taxonomy

A key communication tool for the market

- Mobilization of capital at scale for sustainable development needs a technically robust classification system to establish market clarity on ***what is „sustainable"***.

- According to the HLEG and the EU Action Plan, the **taxonomy** (categorization),
  - shall provide detailed information on relevant sectors and activities, based on screening criteria, thresholds and metrics,
  - should be aligned with the EU's public policy goals (including implementation of PA and SGDs) to link up with real economy assets
  - shall thus provide the foundation to turn national transition trajectories into national capital raising plans, communicate these to capital markets for maximum support from private sector
  - shall be applicable for all types of assets and capital allocation
  - would provide capital market actors with guidance on the relevance of specific activities, so investment decisions and allocations can be taken accordingly,,
  - will be also the basis for relevant standards, labels, benchmarks
  - will initially focus on cc mitigation and adaptation, with other environmental and SDG-relevant sectors to follow, being an evolving tool coherent with best available knowledge.

5. Key messages

- **Sustainable Finance** is nothing new; what's new is the momentum behind, driven by both public policy goals and associated large-scale investment needs, as well as by private sector (capital market) interests to harness corresponding opportunities and manage associated risks, thus ranking high on the political and corporate agenda,

- Sustainable Finance has a strong green finance component, given the urgency of climate action (on national, EU and global level), but other components of sustainable development (social, governance, economic issues) need to be equally taken into account,

- The Action Plan on Sustainable Finance is part of the EU's efforts to connect finance with the specific needs of the European and global economy for the benefit of the planet and society; it lays down the foundations for corresponding (potential) EU-wide regulatory and legal reform in line with sustainability goals,

- The establishment of a unified EU classification system – or taxonomy – will be key to further define sustainable sectors, assets and activities as a top priority.

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