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INTRODUCTION

SUSTAINABILITY AND FINANCIAL MARKETS: SOME INTRODUCTORY REMARKS

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The transition towards a more sustainable global economy seems more urgent than ever. Especially the consequences of climate change call for unprecedented efforts to avert the most catastrophic effects.[2] The actors on the financial markets can play a crucial role in a more sustainable development of the world. This is certainly the case for financing the transition to a green and low carbon economy. A trend is taking shape of their sustainability efforts becoming more mandatory (or at least guided). This trend relates to the insight that sustainability issues, such as the transition to renewable sources of energy, can give rise to financial risks for financial institutions that can ultimately threaten financial stability. This raises the question whether supervising bodies can or even must convert these environmental and climate challenges into their policies. The Dutch Central Bank answers this question in the affirmative. It has now declared long-termism and sustainability as spearheads of its policy for the supervision of financial institutions. It also works together with other central banks in the Network for Greening the Financial System, that aims at enhancing the role of the financial system to manage sustainability risks and to mobilize capital for green and low-carbon investments.[3] In the European Union the call for a strategy on sustainable finance has led to the presentation of an elaborate action plan.[4] These examples illustrate the many current developments on the crossroads of sustainability and financial markets that together form the theme of this book.

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2 See the Paris Agreement (2015) and its signatories duties to limit the effects of climate change.

3 De Nederlandsche Bank, *Toezicht. Vooruitblik 2019* (accessible through www.dnb.nl), p. 13-14.

4 European Commission, Action Plan: Financing Sustainable Growth, COM(2018) 97 final (8 March 2018).

Although sustainability seems more in vogue than ever before, the idea itself is as old as the Bible. In the Gospel according to Mark a rich man took pride in his compliance with the ten commandments – that is: the law of God – ever since he was a young boy. He expected to live forever. However, the mere observance of the law deemed insufficient to be granted eternal life. Jesus explained him that is was difficult for a camel to go through the needle's eye, but even more difficult for a rich man to enter the Kingdom of God.[5] In a similar fashion sustainability fosters the idea that enterprises should do more than merely comply with the law. Conducting business in a sustainable manner also means to act in an ethically responsible way. Sustainable business – according to common belief – leads to a better and more fair society. It contributes to innovations, such as the development of sources of renewable energy or healthy food, that can tackle the world's issues on poverty and the protection of the environment. Sustainable business is not aimed solely at return in a financial and economic sense (profitability), but also at return in an ecological sense (environmental protection) and a social sense (social justice).

Sustainability, according to the European Commission, concerns 'the responsibility of enterprises for their impacts on society'. It is part of their *corporate social responsibility*.[6] Corporations, including financials, have acquired a big societal influence. This influence goes beyond their impact on the economy. Their functioning not only affects the interests of its immediate stakeholders, such as shareholders, employees and customers, but also the environment, the climate, the consumption of energy and raw materials, the position of children and women (think of the fight against abuse, modern slavery or unequal treatment). It also affects the interests of commercial practice in broad sense (such as fair trading and the prevention of fraud) and of investments. These various interests can be divided into three main factors: environmental, social and governance (ESG). These factors translate into moral obligations. A failure to observe these obligations can lead to reputational damage and operational risks for the enterprises involved. It could even lead to the downfall of the corporation. More and more ESG factors also translate into enforceable legal obligations for businesses, on the

5 Mark 10:25.

6 European Commission, 'A renewed EU Strategy 2011-2014 for Corporate Social Responsibility, COM (2011) 681 final, p. 6. See also H. Fleischer, S. Kalss & H.-U. Vogt (eds.), *Corporate Social Responsibility*, Tübingen: Mohr Siebeck 2018.

basis of national or international instruments.[7] Non-compliance with these obligations can trigger civil or criminal liability of companies (and their executives) with all the sanctions that accompany such liability. Civil liability could lead to gigantic claims for damages and it raises the question if such liability actually contributes to the solution of the underlying problem.[8]

Sustainability touches all aspects of the enterprise and the management of business.[9] An enterprise that takes its corporate social responsibility would for example reduce its carbon footprint by recycling its waste, using and even generating renewable energy, reducing its consumption of paper and energy and stimulating its employees to use public transport or bikes. It would purchase sustainable goods and services, such as organic food and biodegradable cleaning products. It would improve the social conditions of its current and future employees including the implementation of a diversity policy and the employment of disabled staff. The enterprise would also invest in a sustainable manner. This would mean no investments in companies that produce weapons or tobacco – and in the future perhaps alcohol too –, in companies that do not respect the occupational health and safety of their employees, in companies that pollute the environment or that have committed fraud. A sustainable enterprise would, finally, report on its sustainability policy and performance. Companies such as Sustainalytics or RobecoSAM have developed sustainability reports and ratings on the basis of ESG criteria. Their analysis can lead to a *non financial indicator* (nfi) benchmarking a company's sustainability practices. This score can form a reference point for investors, financiers and consumers alike. A well-known international example is the Dow Jones Sustainability Index, that evaluates the sustainability performance of thousands of publicly traded companies.

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7 Already in 1948 the Universal Declaration of Human Rights formulated (non-enforceable) legal obligations in Article 29. Section 1: Everyone has duties to the community in which alone the free and full development of his personality is possible. Section 2: In the exercise of his rights and freedoms, everyone shall be subject only to such limitations as are determined by law solely for the purpose of securing due recognition and respect for the rights and freedoms of others and of meeting the just requirements of morality, public order and the general welfare in a democratic society.

8 J. Spier, 'Balancing Acts: How to Cope with Major Catastrophes', *Journal for European Tort Law* 2013, 4 (2), p. 223 ff.

9 E.g. A.G. Castermans & C. van Woensel (eds.), *CSR for young business lawyers*, Den Haag: Eleven International Publishing 2017.

Most sustainability rules can be characterized as soft law, meaning that they are not legally enforceable.[10] Well-known are for example the OECD Guidelines for Multinational Enterprises (2011), that provide non-binding principles and standards for responsible business conduct in a global context. It asks, among other things, for a contribution to social and environmental progress and respecting human rights. We also point out the 2030 Agenda for Sustainable Development Goals of the United Nations (2015). This Agenda aims at mobilizing efforts to end all forms of poverty, fight inequalities and tackle climate change. It contains seventeen sustainable development goals, such as gender equality (goal 5), clean water and sanitation (goal 6), affordable and clean energy (goal 7), decent work and economic growth (goal 8), reduced inequalities (goal 10), responsible consumption and production (goal 12) and climate action (goal 13). Not only states, but also businesses and other individuals are called upon to contribute to the achievement of these goals.

In the slipstream of this soft law more and more enforceable legal obligations have come into existence. Its source is often supranational. The European Union has issued for example Directive 2014/94/EU on the disclosure of non-financial and diversity information by large companies. Accordingly, certain large undertakings should include in their annual financial reports a non-financial statement containing information relating to at least environmental matters, social and employee-related matters, respect for human rights, anti-corruption and bribery matters. The disclosure of such non-financial information should help the measuring, monitoring and managing of the companies' performances and impact on society. Another example is the Energy Efficiency Directive that requires many European businesses to carry out so-called energy audits and to adopt certain energy saving measures.[11] A last example, concerning the promotion of fundamental rights, is art. 16 of the Treaty on the Functioning of the European Union. It states that everyone has the right to

10 C. van Woensel, 'The framework of CSR', in: Castermans and Van Woensel (Ed.), *CSR for young business lawyers*, p. 97. Zie ook het verslag van de vergadering van de Vereniging voor Burgerlijk Recht van 11 december 2013: P. Kuipers and L.F. Wiggers-Rust, 'Gedragscodes in internationaal, Europees en privaatrechtelijk perspectief. Codes en juridische betekenis, effectiviteit en handhaving', *NTBR* 2014/4, p. 150 ff.

11 Directive 2012/27/EU. The directive was implemented in Dutch law through the Wet van 28 februari 2015 tot wijziging van de Wet implementatie EU-richtlijnen energie-efficiëntie, de Elektriciteitswet 1998, de Gaswet en de Warmtewet in verband met de implementatie van richtlijn 2012/27/EU betreffende energie-efficiëntie, *Staatsblad* 2015, 102.

the protection of personal data concerning them. The protection of personal data is also ensured in art. 8 of the Charter of Fundamental Rights of the European Union. Resulting therefrom the General Data Protection Regulation (GDPR) was issued, which entered into force in 2018. According to art. 24 GDPR the controller shall implement appropriate technical and organisational measures to ensure the compliant processing of data.

In this book we focus on this type of hard law, meaning binding and enforceable legal obligations that relate directly or indirectly to sustainability. Moreover and as mentioned above, the focus lies on sustainability and the actors in the financial markets. Sustainability issues can give rise to physical risks (e.g. climate change damage), transitional risks (e.g. costs for implementing ESG policies), reputational risks (e.g. through negative (social) media attention) or liability risks (e.g. liability for ESG-related damages). A financial undertaking also runs an indirect risk as it holds investments or is financially exposed to other companies that might be liable or that face high transition risks. The awareness of these new risks is growing. It raises the question which measures to control these risks should be taken. This book aims at mapping out several of the risks for financial undertakings that relate to sustainability, especially climate change risk, and that have enforceable legal consequences. The book is divided into chapters. It starts with the more general topics and then tilts towards the more specific ones. General topics are the role of current and future banking regulation and the prospect and consequences of climate change liability for the financial institutions in particular. Specific topics concern the role of management, the position of pension funds and the developments in sustainability reporting.

The first chapter deals with the useful role of banking regulation to encourage banks to support sustainability and to address the financial risks associated with sustainability issues. The second chapter builds on this and zooms in on the European Commission's action plan on sustainable finance. This plan aims to reorient capital flows towards sustainable investments, to manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues, and to foster transparency and long-termism in financial and economic activity.

The third chapter turns to the likelihood of liability for climate change losses. Although its threat might foster the necessary adequate and sufficient action, actual liability for climate losses may have far-reaching and undesirable consequences for the society as a whole. In the fourth chapter the issue of climate liability is discussed in the context of the financial sector. It is argued that the financial sector requires a fundamental shift to long-termism to contribute to the addressing of climate change issues. Legislation and litigation alone may not be enough in this respect and the authors call for global multi-stakeholder multi-level initiatives in the financial sector to speed up the sustainability efforts. The fifth chapter takes on public interest litigation and the influence of soft law on climate change liability. It zooms in on the duty of care for financial institutions and its potential expansion in the scope of soft law instruments.

The sixth chapter takes a turn to prudential supervision. It discusses whether the competent supervisory authorities may, under the existing legal framework, require Eurozone banks to hold additional capital in view of their climate risks. Future green monetary policies and their conformity with the EU Treaties are the topic of chapter seven. These treaties may not only allow such monetary policies, but might even require such action against global warming.

In chapter eight we turn to the role of the management of financial institutions. More specifically the chapter zooms in on the fit and proper assessments and discusses whether this supervisory practice can provide financial supervisors with additional tools to stimulate financial institutions to seriously address and mitigate climate-related risks in their businesses. Chapter nine deals with management from the perspective of director's liability for climate change risk. Directors may be personally liable for failing to adequately govern the risks associated with climate change. Chapter ten is devoted to the position of pensions funds. It discusses in particular the question whether the prudent person rule allows European pension funds to take account ESG factors in their investment policy. Finally, chapter eleven explores the development of sustainability reporting. The analysis focuses on the various frameworks for integrated reporting and sustainability reporting with regard to listed companies and financial institutions in the European Union.

CHAPTER 1

BANKING REGULATION AND SUSTAINABILITY

Kern Alexander & Paul Fisher[1]

1. Introduction

The 2030 United Nations Sustainable Development Goals place climate action and environmental challenges as central to the required transformation of the global economy to "end poverty, protect the planet and ensure prosperity for all". Following the landmark commitment to limit global warming, made by the world's governments meeting at COP21 in Paris in 2015, the G20 and its Financial Stability Board (FSB) have expressed concerns that climate change represents a major threat to the future stability of the global economy. The G20 set up a Sustainable Finance Study Group and the FSB commissioned the Task Force on Climate Related Financial Disclosures (TCFD). This chapter seeks to answer the question of how banks, and banking regulation in particular, can contribute to sustainability objectives.

Most governments seek to smooth economic growth as far as possible, at the highest rate, in order to maximize living standards. Monetary and fiscal policy objectives are generally set to dampen the business cycle (5-7 years) and the credit cycle (10+ years) so as to deliver monetary and financial stability. Sustainability risks can be defined as those which might crystalize over the longer-term horizon of a generation or more (25 years). As governments become more aware of such risks, policy is shifting to mitigate them. Growth which continually raises global temperatures and over-uses the world's resources, for example, will eventually risk a global economic catastrophe, not just an environmental one. If there is a trade-off and hence a policy choice here, it is not between growth and social outcomes. Rather it is between short-term unsustainable growth and longer-term sustainable growth.

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Mark Carney, Governor of the Bank of England and FSB Chair, called this 'The tragedy of the horizon'[2] since the costs of taking action are borne in the short-run but the benefits accrue to future generations. The interaction of that observation with the political cycle in most countries means that the appropriate actions for achieving long-term sustainability may be delayed, making the eventual actions to avoid disaster – or in dealing with it once it happens – much more costly.

Many studies have demonstrated the links between environmental sustainability challenges and economic and financial risks.[3] Environmental and social risks are becoming systemic and a potential threat to financial stability.[4] The main environmental sustainability risks – physical, transition and liability risks – can represent negative externalities for the banking sector and the broader economy. For most countries, banks play a crucial role in providing credit and allocating investment capital that can be used to mitigate these risks whilst enabling the economy to grow and become more resilient to sustainability challenges.

This chapter discusses how, within this wider policy context, prudential regulation and supervision can help to direct, incentivize or encourage banks to support sustainability. In particular, how they can address the financial risks associated with sustainability issues. The focus is mostly on climate change and environmental risks, but the analysis generally carries over to the broader sustainability agenda. Our view is that the existing global regime for prudential regulation – the Basel rules – already has sufficient provisions to enable supervisory authorities to assess whether banks are managing sustainability risks properly. And since the risks are financially material, both the authorities and authorized firms have a legal duty to manage them. Nonetheless, international regulation may need to play a larger a role in developing harmonized standards for bank risk governance and business model assessment. This would be justified by the

2 M. Carney, 'Breaking the Tragedy of the horizon – climate change and financial stability', speech to Lloyd's of London, September 2015.

3 See Bank of England, 'The impact of climate change on the UK insurance sector, a climate change adaption report by the Prudential Regulation Authority', London, September 2015, 33, 34, 45, 46 and 48. See also Bank of England Prudential Regulation Authority, 'Transition in thinking: The impact of climate change on the UK banking sector' September 2018 <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector> accessed 24 October 2018.

4 The World Bank, 'World Development Report 2014 – Risk and Opportunity – Managing Risk for Development', Washington, 2013.

proposition that, where such risks are material for firms they can create systemic risks to the banking sector as a whole, which may not be factored into the decisions of individual firms. As banks are the largest providers of credit in many economies, how they manage these risks collectively is an important policy and regulatory concern.

This chapter consists of four further sections and a conclusion. Section 1 discusses the crossover between the banking sector and environmental sustainability. Section 2 considers some of the main regulatory standards and supervisory approaches that are emerging from best practice to address environmental sustainability challenges. Section 3 considers some specific recent international and regional initiatives which address how financial regulation and environmental, social and governance (ESG) factors can be incorporated into financial regulatory and policy frameworks. Section 4 considers some common challenges in developing more effective regulatory approaches for supervising banks in the context of the challenges and financial risks posed by environmental sustainability.

2. The Banking Sector and Environmental Sustainability

The financial system plays a crucial role in supporting economic growth, by providing credit and allocating investment capital. In many countries, most notably Europe (including the UK) the banks dominate credit provision and creation.[5] Despite borrowing short and lending long, banks have a tendency to exhibit relatively short-term behavior when it comes to risk management, capital and liquidity and the role of banking regulation has in part been to ensure that banks can withstand medium-term pressures, so as to protect the system as a whole. To make growth resilient to longer-term sustainability risks, the banking system can and should be adapted further by taking an even longer-term view.

Most experts agree that the main environmental sustainability risks – physical, transition and liability risks – potentially create negative externalities for the banking sector and broader economy. Prudential regulation and supervision is ultimately about maintaining financial stability and it is

5 Banks have the unique ability to create deposits when lending and so expand their balance sheets *ex ante* without additional funding. So, unlike other credit institutions, they are not just intermediating between savings and investment. See M McLeay A Radia and R Thomas, 'Money creation in the modern economy' (March 2014) Bank of England Quarterly Bulletin Q1, 14-27.

now being recognized that these sustainability risks could be systemic and that regulators therefore have a duty to ensure that they are properly being taken account of.

Under pressure from customers and investors, as well as regulators, banks are already moving to recognise these risks and support the transition to a more sustainable economy by incorporating or mainstreaming sustainability factors into their risk management models and governance frameworks. Risk management is perhaps the key mechanism which enables banks to mobilise and reallocate capital away from unsustainable activities to more sustainable sectors of the economy, whilst still pursuing their commercial objectives. So it is also a key mechanism for prudential regulation and supervision to help drive sustainable outcomes.

As well as managing their own risks, banks also have an important role to play in supporting the broader economy's adaptation to environmental changes and building resilience. By reallocating credit to more sustainable sectors of the economy and managing credit and market risks, banks contribute, in particular, to (i) adapting to the consequences of environmental change over time, (ii) reducing the likelihood of environmental sustainability risks, (iii) mitigating the impact of these risks when they materialize and (iv) supporting recovery from any given impact.

Across many countries, banks have sought to address these risks by adopting different types of 'green' banking practices. Two distinct areas of banking practice have emerged:

i) Development of ESG guidelines with a particular focus on risk management in the area of project finance and reallocating credit to renewable energy resources. The Equator Principles were established in 2003 to provide banks with voluntary guidance for incorporating environmental and social risks into a bank's assessment of credit and operational risks in large infrastructure investment projects. As a result, many large global banking institutions have mainstreamed environmental governance principles into project finance.
ii) Most banks primarily provide short-term credit to large corporates and small and medium-sized firms, and mortgage, savings and investment products to individuals. They are uniquely positioned to mobilise capital for the green economy, including renewable and clean energy projects, by making loans and investments to corporates, structuring specialized transactions and improving the energy efficiency of residential housing by