Join up for team green

Ashley Alder believes it is crucial that Europe and China work together on common standards in green finance to help combat the challenges of climate change

The Paris Agreement may be in trouble. Adopted by parties to the UN Framework Convention on Climate Change in 2015, it sets out a global action plan for the necessary transition to a low-carbon future, in order to limit global warming to below 2°C compared with pre-industrial levels. But scientists have estimated that global industrial emissions of carbon dioxide are likely to have risen by 2.7 per cent in 2018 to reach an all-time high.[1]

Adverse impacts from the increasing frequency of once unusual weather and climate events are being felt around the world. Extreme temperatures, wildfires, floods and storms, which are believed to be linked to climate change, are increasingly disrupting resource availability, production capacity and supply chains, and pushing up business operating and maintenance costs. These could affect energy and commodity prices, corporate bonds, equities and derivatives contracts, and may lead to a reappraisal of prices in certain sectors.

While many of the world's governments are proposing or implementing policies to reduce greenhouse gas emissions, these efforts appear to be falling short of achieving their reduction targets under the Paris Agreement.[2] A few governments are even stepping back from their targets.

If such things continue, the multilateral government approach alone may not achieve the Paris Agreement goals. One option that could help is market-based initiatives with a financial regulatory component.

Some financial regulators have publicly recognised that environmental and climate-related risks are a source of financial risk,[3] in view of the growing impact of climate change on businesses and financial markets. There is also a rethink among financial regulators of their specific roles in green finance, which could be defined as the "financing of investments that provide environmental benefits in the broader context of environmentally sustainable development".[4] The current focus among leading financial regulators is on environmental, especially climate change, risk – an existential risk that is growing. This is not to say that the regulators are completely ignoring the social aspect of environmental, social and governance (ESG) standards in investment, but this often shades into ethical choices as distinct from financial risk.

From the perspective of market regulators who are mandated to regulate participants in the securities and futures markets and to promote market transparency, there are two pressing issues in green finance that have to be addressed.

The first is the need to have comparable, and decision-useful, environmental and climate-related financial disclosures from listed companies, so that asset managers and asset owners who invest globally have the information needed for asset allocation and risk management. This is absolutely critical because unless such information is available, there is not much point in regulators discussing, say, expectations that asset managers take into account environmental and climate risks. Currently, there are differences between local requirements and international reporting frameworks, and also among the many international frameworks themselves.

> *"There is a need for greater harmonisation about the disclosure of environmental and climate risks*

The second key issue is whether, and to what extent, such disclosures should be mandatory, rather than voluntary, or made on a "comply or explain" basis. If regulators decide to mandate disclosure, what will a breach look like? How can regulators detect a breach in disclosure, given that environmental and climate risks manifest over extended periods of time? What will be the potential liability if listed

1. Tollefson J (2018), 'Global Industrial Carbon Emissions to Reach All-Time High in 2018'. *Nature International Journal of Science*, 7 December. Available at: www.nature.com/articles/d41586-018-07666-6.
2. McGrath M (2018), 'Climate Change: CO2 emissions rising for first time in four years'. *BBC News*, 27 November. Available at: www.bbc.com/news/science-environment-46347453.
3. Central Banks and Supervisors Network for Greening the Financial System (2018), *First Progress Report*, October 2018. Available at: www.banque-france.fr/sites/default/files/media/2018/10/11/818366-ngfs-first-progress-report-20181011.pdf.
4. G20 Green Finance Study Group (2016), *Synthesis Report*. Available at: www.unepinquiry.org/wp-content/uploads/2016/09/Synthesis_Report_Full_EN.pdf.

companies fail to disclose? These are important questions that securities regulators have to consider further. There is a need for greater harmonisation about the disclosure of environmental and climate risks. In my view, the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) recommendations have provided a sophisticated methodology for a compelling starting point.

Companies have often focused on disclosing how their businesses or operations affect the environment, whereas the TCFD's focus is the other way around. That is: how companies' financial positions could be affected by risks and opportunities arising from climate change. This is useful information for companies planning their short-, medium- and long-term strategies and it also helps asset managers and asset owners to make investment decisions. This is important if regulators want environmental and climate risks to be managed as any other financial risk, rather than as corporate responsibility issues. Implementing the TCFD recommendations would support the appropriate pricing of risks and capital allocation.

General challenges to green finance and selected country/market practices to address such challenges

	Challenges			Practices
	Banking	**Bond market**	**Institutional investors**	**Country/market practices to address challenges**
Externalities	Inadequate compensations for positive externalities of green projects; Inadequate penalties for negative externalities of polluting projects Inadequate price signals			In addition to fiscal and environmental policies: guarantees, concessional loans, PPP, **demo projects**, **adoption of risk management principles and methods**, green labeling, etc.
Maturity mismatch	Lack of appropriate financing instruments for long-term green projects			**Green bonds**, yieldcos, **collateralized lending**
Lack of clarity in green definitions	Lack of green loan definition	Lack of green bond definition	Lack of green asset definition	**Development of green definitions and indicators**
Information asymmetry	Lack of info on borrowers; excessive risk aversion	Lack of info and monitoring on use of proceeds	Lack of info on assets (environmental impacts and risks)	Voluntary disclosure guidelines for environmental impact and related financial risks, **green bond verification, risk mitigation, policy signals, demo projects, anchor investments**
Lack of analytical capacities	Lack of capacity to assess impact on credit risk	Lack of capacity to assess impact on credit risk	Lack of capacity to assess impact of asset valuation	**Risk modeling, training, ratings, indices**

Source: G20 Green Finance Synthesis Report 2016

As part of the *Hong Kong Securities and Futures Commission's Strategic Framework for Green Finance,*[5] the commission has made it a priority to enhance listed companies' reporting of environmental information emphasising climate-related disclosure, taking into account mainland China's policy direction to target mandatory environmental disclosure by 2020, and aiming to align with the TCFD recommendations. Hong Kong, as China's international financial centre and the world's leading IPO market, is well positioned to complement China's comprehensive and pioneering thinking in green finance.

In 2016, seven ministerial agencies in China[6] jointly published the Guidelines for Establishing the Green Financial System, setting out the official definition of green finance; incentives; a development plan for green lending; green financial products; green insurance and an environmental rights trading market; regulations for green bonds; disclosure requirements for listed companies and bond issuers; as well as risk mitigation related to green finance.

It is crucial that China and Europe, another global leader in green finance, work together to ensure harmonisation of green finance standards. If the coalition of like-minded policy makers and regulators is large enough, real, market-driven solutions to climate challenges will take place alongside, and assist, the different paths to a global political consensus on climate change. ■

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5. Hong Kong Securities and Futures Commission (2018), *Strategic Framework for Green Finance*, 21 September, 2018.
6. The seven ministerial agencies comprise the People's Bank of China, the China Banking Regulatory Commission, the China Securities Regulatory Commission, the China Insurance Regulatory Commission, the Ministry of Finance, the National Development and Reform Commission and the Ministry of Environmental Protection.