Emerging ESG challenges: biodiversity, circular economy, social...

1. Realistic ambitions: what does it mean?

A Central Bank official noted that the title of the session refers to 'setting realistic ambitions for the financial sector'. However it is difficult to measure what is realistic. Was it realistic to introduce the euro and make it thrive. Ambition should be set at this level. Society, clients and citizens are asking not only for finance but for finance to have responsibilities in society. Furthermore, this can be a way to develop business.

An industry representative stated that realistic ambitions must be set for the non-financial sector, including companies from mining and extractive industries, oil and gas industries, the transportation industry, and the building and construction industry. Then the financial sector can decide whether, as an asset manager, bank or insurer, it wants to lend these companies money, insure them or buy their securities.

2. Emerging ESG Challenges

Strong regulation is needed, but other key instruments and actors are also necessary.

A policy-maker commented that regulation alone is not enough, although it will help. Public funds are also needed, not necessarily in the Keynesian sense. Some public money may be needed, but some ability to give incentives to public funds is certainly important. Incentives may come from regulation or from public funds. In addition, public funds and programmes that also include the private sector will be crucial. In the last few years, there has been an important shift in the way things are done from Brussels. The European Commission implements regulations and programmes but has also increased its ability to provide technical support and advice.

An official commented that regulation is helpful and can sometimes be necessary, but it is certainly not sufficient.

An industry representative commented that, in addition to regulation, there is a general expectation of how organisations run their business in the context of environmental, social and governance (ESG).

An industry representative noted that there are instruments other than regulation, for example use of public funds, programmes and technical advice. The issue of regional versus global standards is also important here. Europe has regional standards on how companies should behave. For companies that behave in a different way abroad, although there could be a carbon tax at the European border, there are also bilateral trade agreements. It is possible to do lot of regulation in the financial sector, but something else will be at play in terms of whether cattle raised on land that comes from deforestation are imported. Trade agreements with other regions will also hinge upon biodiversity and water, which is a very powerful instrument.

2.1 A biodiversity crisis in addition to the climate crisis

An official explained that the Taskforce on Nature-related Financial Disclosures (TNFD) is a private-sector initiative that is funded by the public sector. Through the TNFD, the private sector is trying to understand the complex area of nature, biodiversity and climate, and create standards for understanding, identifying and managing risk, and disclosing and measuring against it. The stress testing that has been happening in the Banque de France, the Dutch bank and the Brazilian bank around nature scenarios is really important. In addition to the climate crisis, there is also a crisis of biodiversity of nature, which is creating material risk for companies and the investors and banks that are financing, lending and creating funds around them. The World Economic Forum has published reports on the biodiversity crisis and the numbers are becoming well-understood. However, how to approach this is not well-understood. Climate and nature should not be approached as separate issues.

A Central Bank official commented that awareness on climate is already increasing. However, climate cannot be separated from other nature-related risks.

An industry representative noted that biodiversity has been rapidly rising on the agenda of investors and is probably the primary focus for 2022. The damage caused by biodiversity loss will be over $10 trillion by 2050. Half of gross domestic product (GDP) is moderately or severely dependent on nature. Climate change is one of the main drivers of biodiversity loss. Action should be taken on both of these in equal measure, given that they are pressing and interconnected.

An industry representative indicated that the research unit at their organisation created a biodiversity index three years previously, recognising that nature is an asset with economic value, calculating everything on the planet in terms of percentage of GDP and making nature a percentage of GDP. This enabled links to be made between biodiversity elements like water, air quality and pollution and economic activities. A map and an index were produced, showing the link between economy activity and nature's inputs to economy activity. This demonstrates how exposed some areas are to challenging biodiversity. 55% of GDP is linked to biodiversity and 20% of countries on the planet are exposed to significant economic consequences if action is not taken on biodiversity.

An official stated that scientists have demonstrated that it will not be possible to decarbonise energy supplies or transport in the necessary timeframe and therefore carbon offsets will be needed. There have been lots of reports about mechanical or artificial carbon offsets that are not very efficient, effective or cheap. The most effective and most-used carbon offsets will be nature-based. The integration between climate and nature must be considered. Initial work was on climate, but a framework must be developed quickly that considers the two together.

An industry representative noted that water is also a very important issue. Oceans and marine ecosystem certification is connected to nature and biodiversity as well as to climate.

3. ESG is a multidimensional challenge and requires an integrated solution

A Central Bank official summarised that a major challenge is whether all aspects of ESG can be addressed together, or whether there is a need to focus. Institutional investors have already done a great deal of work on the G, but perhaps more as an opportunity than as a risk factor. The S is still very underdeveloped. E includes climate and other things. Work on the different elements is moving at different paces. Climate, nature and biodiversity are linked and cannot be separated. If financial institutions and Central Banks, as investors, develop a framework for how to manage these risks and focus only on climate, other aspects may be forgotten. All aspects should be addressed in parallel, acknowledging that the paces can be different. Biodiversity, circular economy and social aspects are considered very similarly. Progress is still in the early stages but it is necessary. There are similarities in the aspects of negative externalities and how they are priced, inclusion in regulation and pressure of expectations of citizens.

An industry representative stated that the challenge of ESG is that there are no strong concepts of how this should be treated.

An official noted that the 2030 agenda has brought about a major paradigm shift in the need to consider sustainable development in a systemic manner and to treat the sustainable development goals (SDGs) as a compact, rather than as a juxtaposition of 17 independent goals. However, there is currently no indisputable conceptual framework for sustainable development. This is what makes the implementation of the agenda so difficult. Sustainable development is very much context-dependent, as each individual or group of people can act in a certain way, depending on their desire for the future. This superposition of visions leads to a permanent debate on sustainability and innovation. This debate is important, but it is sometimes complicated to understand each other. The social, political and institutional process is probably the core of sustainability. It should be supported and reinforced by constantly seeking open spaces, such as the current debate, enabling people and organisations to fully consider the package together. Similar considerations should apply also to ESG.

An official stated that the planet does not care whether the different aspects of ESG are tackled separately or together. Climate and nature are integrated. Climate risk manifests itself in food production. With the increasing temperature of the oceans, the destruction of the reefs and all the reports about land fertility and productivity, climate change is damaging the ecosystems needed to produce food. Therefore, these two things cannot be separated. The different issues are sometimes treated as though it is possible to address one and then the other. These are integrated issues for the planet and an integrated solution is needed.

An official commented that the ESG challenges are not additional to pre-existing ones. They are consequential. It is not very efficient to think that there is some arbitrage between them. Aligning finance with the SDG agenda has become a new theory of change that can be taken into account.

3.1 A common legal framework will lead to a more efficient impact

An official noted that, in most cases, it is not yet illegal to emit carbon dioxide or greenhouse gases like methane. It is illegal to fish without permits, to cut down forests without permission, to destroy species or to pollute, and so the legality framework of nature and biodiversity versus climate is quite different. The financial industry can have an input here. Often the actors involved in illegal deforestation, fishing or human trafficking are connected to money laundering. Many countries, such as France, Singapore and the UK, have started to consider implementing screening measures to ensure that companies are not involved in illegal forestry, fishing, wildlife trafficking and other things that are so damaging.

An official commented that the legal framework for nature and biodiversity can be executed more quickly than the legal framework for climate. Banks and financial investors take anti-money laundering (AML) regimes very seriously. The fact that these are coming is quite encouraging, because it means that legal frameworks can start to be relied upon. There is a great deal of emphasis on trade deals currently. The carbon or nature footprint and nature-positive dynamics of that trade and those imports should be considered. Illegality in those trade deals should be considered. This is a really important part of the regulatory framework. Including the legal framework of illegal forestry, fishing and wildlife trafficking could have an immediate impact.

An industry representative stated that the legal point is very valid. Deforestation takes place outside Europe in Asia, Africa and Latin America, so it may not be illegal everywhere. The issue then is where economic flows are cut. If a company does not carry out deforestation, the question is whether it is acceptable for it to trade with companies that do it legally in their jurisdiction. The measurement issue is very difficult. There are other ways to address that and the legal aspect is a very strong lever.

A Central Bank official commented that pricing does not always work for biodiversity. Using legal norms might work much better. Central Banks are not the ones that are setting the limits or the norms on biodiversity, but they, as well as regulators, can work this through in the right kind of framework, using the right kind of legislation.

3.2 Raising awareness

An industry representative noted that one of the biggest challenges is around companies understanding their dependencies and reporting on these impacts. Engagement is vital, as well as raising awareness and understanding these issues and how they all interconnect. The data may not be available, but there is an awareness that this is important. Even with qualitative information, a lot can be done. This is not only about trade and the legal framework, but also about the role that the industry can play to drive change and ensure that these nature-related risks are understood at the board level.

An industry representative explained that the commitment to sustainable finance is linked to the awareness that the growth model, where negative externalities are not taken into account, will not work. It is not possible to continue to grow in that way for another 300 years, because the planet will not be able to sustain it. This has also been part of the political discussion in the Nordic countries, as well as a part of the expectations on banks and asset managers.

3.3 A focus on brown companies is needed

An industry representative noted that a transition is currently underway. It is one thing to have all the green companies, but the biggest difference is when organisations also engage with brown companies and make them improve. The top 200 emitters in the industry representative's organisation's portfolios typically sit within what are known as Article 6 funds. These are funds that are not seen as ESG funds. Engagement with the Article 6 fund constituents is a priority, because that is where the biggest real world impact can be made.

An industry representative commented that progress starts with the big industries that are using the real assets and natural resources. The question is how to engage with these companies, because there is no way to fly planes without emitting greenhouse gases, but how much capex is expended to have lower emissions needs to be discussed with companies that are insured or invested in by the financial sector.

3.4 Maintaining this ambition is also challenging

An official commented that regulators must be included in the discussion. Private sector mobilisation is also needed. Ambition must be maintained to augment corporate and social responsibility by incentivising financial institutions not only to manage risk and promote sustainable development opportunities, but also to take ESG into account in their general strategy as being something fundamental for them. Access to data is not always easy, but is a potential approach to the identified challenges.

An industry representative noted that comparable data and the ability to see what good looks like is missing. The industry representative's organisation has a team of biodiversity experts, but access to the necessary data to be able to make progress from a regulatory perspective is a challenge.

A Central Bank official stated that collecting data on biodiversity and biodiversity risks is complicated, because there are many facets and the data are not always available. It is important for central banks and financial institutions to work together with experts. The official's Central Bank is investigating whether, by combining data sources in an innovative way, it is possible to gain an understanding of the physical risks of biodiversity. On a standalone basis, data might not provide any insights, but it might be more useful if data-analysis techniques are used.

An industry representative stated that there was a huge mobilisation of the public and private sector to combat commodity-driven deforestation. In order to be able to realise these huge ambitions, better data is needed. The work of the TNFD is needed. The biggest challenge in data is the need to move beyond whether companies have policies in place and to look at the impacts. It should be possible to compare impacts on different species and habitats between companies. Getting more visibility into supply chains is another major challenge. Investors are still far away from where they would need to be in order to be able to track, measure and put pressure on companies through their stewardship activities.

An industry representative noted that Europe is on a path of getting sustainability-related data from almost all economic actors. The industry representative's organisation is a global company with a global footprint and therefore supports dialogue and global convergence on sustainability reporting standards. Convergence is an idealistic scenario, but strong ambitions will ensure that there is some progress and alignment. Internal discussions in the industry representative's organisation focus on the different reporting requirements and developments across the world. A global perspective is needed, because climate change risks have a global coverage and underwriting of (re)insurance risks happen on a global basis as well.

4. ESG also brings new opportunities

An industry representative commented that, in addition to a risk, protecting and restoring nature is also a huge opportunity. The industry representative's organisation is launching a biodiversity fund. Research indicates that, for every dollar invested, up to $30 in benefits can be generated. The Sustainable Markets Initiative and the COP-launched Natural Capital Investment Alliance are seeking to mainstream this as an investment theme. Organisations that are not yet investing in nature are encouraged to join this initiative.

4.1 PDBs could be part of the solution

An official explained that the Finance in Common movement gathers all public development banks (PDBs) and development finance institutions (DFIs) around the world. The PDBs gathered for the first time in 2020 in Paris and formed a global coalition. The objective is to promote cooperation among PDBs in order to tap the full potential of the PDB system to help align finance with SDG-compatible pathways. Policy could help to make sustainability the new norm in finance. The PDBs invest $2.5 trillion each year, which is 12-13% of annual global investment. The remainder comes from government budgets and the private sector. Building the bridge between PDBs' investments with government and the private sector, between domestic and international agendas, between global liquidity and macroeconomic solutions is the current position. PDBs can help to mobilise direct investment, public investment and private finance flows to build back better on a sustainable-development investment track.

An official concluded that governments must reinforce the social development mandate of the PDBs, and regulators and supervisors should provide incentives. This can be by fostering the market transparency of sustainable finance and related disclosure requirements and by elaborating frameworks on asset-based criteria, including a full mobilisation of the whole financial sector to flow capital towards those projects. The financial sector does not just align the supply. It also aligns the demand and builds projects in that mindset. Much work remains to be done on ESG.