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XI.104 Sustainable finance

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Abstract
Sustainable finance, as a distinct category of finance, entails the introduction of environmental, social and governance (ESG) considerations into financial decision-making. Previous work at the international level such as the UN Principles for Responsible Investment and the Global Compact have linked economic activity to sustainable development. The G20 and manifold organizations, backed by the UN but also autonomously, currently elaborate principles, prepare recommendations and generally align their forces with a view to mobilizing private and public capital for 'green' purposes. Higher returns but also risk management are good reasons for the financial sector to participate in such efforts. The current WTO framework, and more specifically the General Agreement on Trade in Services (GATS), could offer some avenues for advancing global cooperation in the area of sustainable finance and attenuate potential frictions due to regulatory fragmentation.

Keywords
Sustainable finance, responsible investment, environmental, social and governance (ESG), General Agreement on Trade in Services (GATS)

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XI.104.1 From sustainable development to sustainable finance

Climate change adaptation and sustainable development more generally cannot be made possible without the necessary financial means being available to the relevant actors leading the transformation of the global economy in an environment-friendly manner. Identifying the relevant sources of finance for advancing sustainable development and accelerating the transition towards a low-carbon and more circular economy across the globe has become one of the major challenges for governments and private actors alike. The 'green transformation' that is needed to save the planet requires substantial investments in infrastructure and innovative technologies. Public sector spending alone cannot cover the breadth of the capital needed to achieve the ambitious objectives set by the international community. Rather, private investment must be streamlined to finance investments that can ensure a resource-efficient future.

At the highest level of global cooperation, the G20 initiated work on green finance in 2016, following the adoption of the Paris Agreement on climate change (which recognized the vital role of the financial system in promoting responsible development) and the UN 2030 Agenda for Sustainable Development in 2015 (including the sustainable development goals or 'SDGs' whose implementation was estimated to require total investments in the range of US$5 trillion to US$7 trillion every year). The G20 initiative underscored the importance of taxonomy and definitions and the options available for the necessary mobilization of private capital for green investment. An important aspect of the latter is legal certainty, which can provide to financial investors the signal they seek in order to take a medium- to long-term investment decision.[1]

The most important follow-up initiative of the G20 action is the International Platform on Sustainable Finance (IPSF). Launched in October 2019, its now 16 members (counting the EU as one), representing half of the world's population and GHG emissions, agreed to join forces to scale up the mobilization of private capital through the design and monitoring of regulatory measures, the promotion of best practices, the exchange of information, and the identification of opportunities and barriers in relation to sustainable finance. In theory at least, convergence among a subset of members (for instance, through recognition of equivalence or otherwise) is also possible under the IPSF. The IPSF initiative is the result of a general acknowledgement that, at the policy level, global collaboration and eventual convergence on taxonomies, standards, labels and disclosure will be essential to support the green transition.[2]

The financial sector is key in the pursuit of a greener and more sustainable economy. However, a shift towards more sustainable investment can occur only if a combination of top-down (think of governments, central banks, international organizations and multilateral agreements, or the European Commission) and bottom-up forces (think of corporate social responsibility strategies that financial institutions adopt independently or investors insisting on making investment decisions with sustainability as the main criterion) come together with a view to promoting sustainable economic growth.

XI.104.1.1 The importance of ESG for sustainable finance

Sustainable finance typically calls for environmental, social and governance (ESG) considerations or principles being taken into account when decisions are made in the financial sector by financial market actors, financial market policymakers with respect to financial services, products, processes, and related institutional and market arrangements. Sustainable finance practices focus on the pursuit of a positive environmental impact of investments, broadly defined. One could trace the idea of incorporating ESG issues into investment analysis and decision-making back to the UN Principles for Responsible Investment (PRI).[3] Recall that the PRI framework was launched in April 2006 at the New York Stock Exchange by the world's largest institutional investors following an initiative by the then UN Secretary-General Kofi Annan. Since its launch, the

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[1] See G20 Leaders' Communiqué Hangzhou Summit, 4–5 September 2016, para. 21.

[2] See IPSF Annual Report, 16 October 2020, available at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/international-platform-sustainable-finance-annual-report-2020_en.pdf.

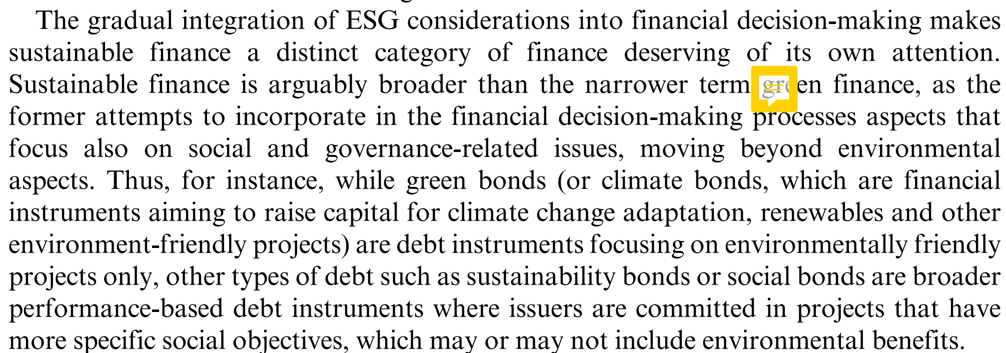
[3] See Principle 1 of the PRI framework.

initiative has attracted a lot of attention, growing from 100 signatories initially to over 3,000 signatories.[4]

A more recent initiative of similar magnitude is the one relating to certain sets of industry-based principles developed within the framework of the UNEP finance initiative (UNEP FI) in collaboration with the global financial sector. These are the Principles for Sustainable Insurance, established by the UNEP in 2012, applied currently by one quarter of the world insurers, and, more recently, the Principles for Responsible Banking, developed in cooperation with one third of the global banking sector in September 2019.

Sustainable finance could arguably be regarded as an evolutionary concept that the PRI framework triggered. Having said this, whereas the common denominator is the incorporation of ESG metrics into capital allocation, the concept of sustainable finance is broader because it includes asset management and product development but also ownership and stewardship criteria. Still, the trend of large institutional investors and asset owners, such as various pension funds, to badger the companies that manage their money to invest in companies that adhere to ESG largely began around the time of the adoption of PRI, and the latter clearly played a role in promoting ESG-related considerations in an ever-increasing number of economic activities.

The gradual integration of ESG considerations into financial decision-making makes sustainable finance a distinct category of finance deserving of its own attention. Sustainable finance is arguably broader than the narrower term green finance, as the former attempts to incorporate in the financial decision-making processes aspects that focus also on social and governance-related issues, moving beyond environmental aspects. Thus, for instance, while green bonds (or climate bonds, which are financial instruments aiming to raise capital for climate change adaptation, renewables and other environment-friendly projects) are debt instruments focusing on environmentally friendly projects only, other types of debt such as sustainability bonds or social bonds are broader performance-based debt instruments where issuers are committed in projects that have more specific social objectives, which may or may not include environmental benefits.



Each one of the three categories of considerations are linked directly or indirectly to climate change and sustainable economic growth: environmental considerations relate to climate change adaptation and mitigation (greenhouse gas emissions and renewable energy being the most obvious ones) but also the environment more generally (for instance, air and water pollution, depletion of resources, biodiversity-related damage and waste management) and related risks such as natural disasters. Social considerations, on the other hand, aim to bring to the forefront ever-increasing concerns about persisting inequalities, inclusiveness, labour relations, human rights protection, or investment in human capital. Finally, governance-related considerations touch upon corporate management structures regarding shareholders, employee relations and executive remuneration, including but not limited to transparent reporting, corruption and bribery avoidance mechanisms and board accountability structures.

[4] One could even go a bit further into the past and underline at this juncture the importance of the UN Global Compact launched in 2000, which has been the world's largest voluntary corporate sustainability initiative, calling for the alignment of business operations with 10 principles in the areas of environment, human rights, labour and anti-corruption.

All three categories of considerations identified above are interrelated: climate deterioration can accelerate social challenges such as inequalities, whereas governance-related interventions can make sure that social and environmental considerations are taken into account in investment decisions specifically and more broadly in the decision-making process.[5] The broader objective is to increase the sheer number and volume of corporate investments in economic activities and projects whereby sustainable development concerns are key, thereby redirecting existing financial resources towards achieving the SDGs. In doing so, the financial system can have a positive impact on collective welfare.

Most notably, it can address (or prepare with a view to addressing) climate-related financial risks and, thus, assist in creating more resilient societal and economic structures. Such risks may entail physical risks (for instance, those associated with environmental degradation and resource depletion as well as social issues that accompany such phenomena); transition risks (for instance, how to cover losses due to the decarbonization of the economy); and liability risks (for instance, claims associated with physical or transition risks that liability insurance providers have to cover).[6] Clearly, some segments of the financial sector are concerned about climate change and the risks it entails more than others: for instance, climate change is for the global insurance industry the greatest risk that the industry is facing, which has started leading to important changes in policy and the relevant regulatory framework, as well as significant resources being diverted into the optimization of risk modelling, management practices and mitigation strategies.

Thus, while responsible finance dates back at least to the early 2000s, it is only recently that ESG metrics became part and parcel of corporate investments. Since 2015, ESG investment funds have increased the total assets they manage by more than 170 per cent. In the first ten months of 2020 alone, European ESG funds witnessed net inflows of over €150 billion, which is about 80 per cent more than in the same period in 2019. The exponential growth and the current straightforward trend towards more ESG investment is reflected best in the debt markets: in the period 2012–2018, the sustainable debt market grew from some $10 billion per year to about $250 billion. Whereas green bonds, which at end-2020 exceeded US$ 1 trillion in cumulative value since inception (reflecting an annual growth of 60 per cent since 2015), represent the lion's share of that market, sustainability-linked loans have witnessed impressive growth rates as well.[7]

At present, green bonds at the corporate level experience significant success; examples include bonds issued by Apple ($1.5 billion in 2016 and $2.2 billion in 2019) as well as Iberdrola, QBE Insurance Group, Unilever and TenneT. For investors, green bonds produce a significant credible signalling effect – that a given company is committed to an environmental cause. As this commitment is adhered to, companies reduce their CO_2 emissions, attain higher environmental ratings and become attractive for environment-sensitive investors.[8] Sovereign green bonds have also seen a sharp increase in recent years with a view to financing renewable energy and sustainable infrastructure projects.

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[5] See also European Commission Communication, 'Action Plan: Financing Sustainable Growth', COM(2018) 97 final, 8 March 2018, at 2.

[6] See Financial Stability Board, 'The Implications of Climate Change for Financial Stability', 23 November 2020.

[7] See Landberg et al. (2019).

[8] See Flammer (2021).

At the local level, green bonds are also quite attractive for municipalities in order to help cities and local communities in their fight regarding climate change adaptation and mitigation, including energy efficiency and green building programmes, biodiversity conservation, or sustainable water management.

More intensive efforts to channel funds towards ESG-related financial instruments may however be necessary: According to the European Commission, new investment of over €260 billion per year will be needed for the EU to meet its 2030 climate target. The OECD, on the other hand, estimates that no less than $7 trillion of infrastructure investment (including transport, water and sanitation, telecommunications and energy supply and use) is needed on a yearly basis to meet the SDG goals by 2030 in a manner that is also in conformity with the Paris Agreement, that is, in a manner that can lead to achieving the 2°C temperature goal.[9] About two-thirds of the required infrastructure investments shall occur in developing and emerging economies. However, the level of annual investments globally is almost halfway through, at about 4 trillion annually.[10] To understand the relative magnitudes and issues at stake here, subsidization of fossil fuels has remained large, exceeding $5 trillion in 2017, with China, USA, Russia, EU and India leading this race of inefficient subsidies.[11]

Such targets may be challenging to achieve not just because they are relatively ambitious but also because market correction is taking place, as definitions, taxonomies and reporting standards relating to sustainable finance and responsible investing are shaped. Efforts at the international, regional and domestic level aim at allowing for the establishment of an accurate picture of the actual volume and associated flows, but also targets greenwashing, that is, a misleading or overstated depiction of ESG-based investments – or commitment thereto. Greenwashing may occur in the form of selective disclosure, misleading visuals or narratives, as well as deceitful ecolabels.[12] Governments clearly have an important role to play in rendering corporate disclosures mandatory and credible based on comparable and reliable ESG metrics and benchmarks.[13]

By the same token, central banks can accelerate a green transition with credible fundamentals on the side of the financial system. One important initiative at this level is the creation of the Network for Greening the Financial System (NGFS), a network of over 80 central banks and financial supervisors created in 2017 in Paris with the mission to promote the development of best practices in climate risk management and to generate analytical work on sustainable finance.[14]

However, a more bottom-up approach can also lead to tangible results: for instance, the Financial Stability Board (FSB) spearheaded the creation of an industry-led task force: the Task Force on Climate-Related Financial Disclosures (TCFD), tasked with the development of voluntary climate-related disclosures, thereby assisting in the identification of the information needed by investors, lenders and insurance underwriters

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[9] See OECD (2017) at 102.
[10] See OECD (2018) at 84.
[11] See Coady et al. (2019).
[12] See Lyon and Montgomery (2015).
[13] The Economist, 'The Trouble with Climate Finance: Green Investing Has Shortcomings' (18 June 2020).
[14] See https://www.ngfs.net/en.

to understand and properly assess and price climate-related opportunities and risks. In 2017, the TCFD published a set of recommendations for more effective climate-related disclosures that could promote better-informed investment, credit and insurance underwriting decisions.[15] In the UK, for instance, such disclosures based on the TCFD framework will be mandatory for listed and large private companies by 2025.

Overall, initiatives of varying degree, commitment and activity currently develop networks and establish partnerships that, intentionally or not, create an increasing level of alignment relating to sustainable finance. Among many, we would mention here the UN-convened International Network of 33 Financial Centres for Sustainability (FC4S network); the UN-convened Sustainable Insurance Forum, whereby 30 insurance supervisors and regulators, representing over 90 per cent of the global insurance market, share knowledge on supervisory practices and conduct research on emerging risks (most notably on climate-related risk on the insurability of assets, sustainability beyond climate change and climate risks in actuarial processes); and a collective project run by big cities, the C40 Cities initiative.

Regulatory advances in precisely defining what type of investment or financial instruments should be considered as sustainable have led to a better, more rationalized reporting of asset value, particularly in Europe. However, uncertainty still looms large, as to date universal rules and widespread and reliable standardization efforts are lacking, potentially resulting in market fragmentation and undermining the effectiveness, efficiency and fragile integrity of the relatively nascent market. Still, notable global certification schemes are flourishing, bringing more confidence in the environment-friendly credentials of climate bonds, loans and other financial instruments. One positive example is the Climate Bonds Standard and Certification Scheme of the Climate Bonds Initiative,[16] which identifies sector-specific eligibility criteria for assets and projects that can be used for climate and green bonds. Importantly, the Climate Bond Standard allows certification of a bond prior to its issuance, thereby making credible any marketing effort of the issuer.

XI.104.1.2 Regulation of sustainable finance in the EU

The EU has pioneered collaboration on the establishment of a sustainable finance framework at the regional level. Such efforts have been building on the G20 work and internal legislative developments on climate action and sustainability. The EU Action Plan on sustainable finance revealed the EU's strategy for the medium run, which revolves around three axes: first, reorientation of capital flows towards sustainable investment; second, management of financial risks stemming from climate change, resource depletion and environmental degradation but also social issues; and, third, strengthening transparency and a long-term value creation mentality in financial and broader economic activity.[17]

The European Green Deal launched by the new EU Commission in 2019[18] calls for the preparation and implementation of a renewed sustainable finance strategy to finance

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[15] See https://www.tcfdhub.org/recommendations/.
[16] https://www.climatebonds.net/ (accessed 30 January 2021).
[17] See above note 5.
[18] European Commission Communication, 'The European Green Deal', COM/2019/640 final, 11 December 2019.

the green transition. The investment pillar of the European Green Deal, known as 'the Sustainable Europe Investment Plan', aims to mobilize at least €1 trillion of private and public sustainable investment until 2030.[19] That strategy builds on the Action Plan but links the effort to other EU initiatives and instruments such as the Next Generation EU, a recovery instrument that intends to lead to the recovery of the EU economy in the aftermath of the Covid-19 pandemic. Three main pillars for intervention have been identified.

The first pillar is strengthening the foundations for sustainable investment. A key step in this respect was the adoption and implementation of the Taxonomy Regulation, setting the foundations for a classification system for sustainable economic activities.[20] The Regulation focused on identifying in an exhaustive manner six environmental objectives to which economic activities should contribute in order to be considered as environmentally sustainable for investment purposes (note that the Regulation keeps open the possibility for a legislative act identifying a set of social objectives at a later stage). In doing so, the Regulation aims at harmonizing at the EU level the criteria for a given economic activity to qualify as environmentally sustainable. Regarding its personal scope, the Regulation applies to financial market participants that offer financial products; financial and non-financial undertakings that come under the scope of the Non-Financial Reporting Directive;[21] to Member States and the EU when they introduce national and EU-level requirements applicable to financial market participants or to issuers for the purpose of labelling financial products or corporate bonds that are marketed as environmentally sustainable.

The six objectives that the Regulation prioritizes are: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems. According to the Regulation, a key step for harmonizing taxonomies would be the identification of uniform criteria for determining whether economic activities contribute *substantially* to any of those environmental objectives. Other than the principle of 'substantial contribution', the Regulation also incorporates the principle of 'no significant harm', which is an important corollary of the former principle, providing that an activity that substantially contributed to one of the six objectives may still be regarded as unsustainable if it causes significant harm to another environmental objective of the remaining five.

Importantly, the Regulation also introduces as a criterion for the sustainability of a given economic activity the compliance of a relevant economic actor with the OECD guidelines for multinational enterprises and the UN Guiding Principles on Business and Human Rights, including the basic ILO conventions.

In June 2021, a delegated act on climate change mitigation and adaptation was adopted, which offers some clarity on the technical screening criteria to be used that shall

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[19] European Commission Communication, 'Sustainable Europe Investment Plan – European Green Deal Investment Plan', COM(2020) 21 final, 14 January 2020.

[20] See Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, and amending Regulation 2019/2088 [2020] OJ L198/13.

[21] Directive 2014/95 on disclosure of non-financial and diversity information by certain large undertakings and groups, [2014] OJ L330/1.

be used in determining under what conditions a given activity relating to climate change adaptation or mitigation makes a substantial contribution to a given environmental objective and does not significantly harm the other objectives identified in the Taxonomy Regulation.[22] Clarifications for the remaining four environmental objectives should be expected through the adoption of delegated acts in 2022.

A mandatory disclosure regime for financial and non-financial companies constitutes a building block of the EU sustainable financial framework. The first important legislative instrument in this regard is the Sustainable Finance Disclosure Regulation (SFDR), which applies as of March 2021 to sellers of investment products and financial advisers and aims at offering the necessary entity- and product-level disclosure on sustainability-related risks and adverse impact to allow for informed decisions by investors.[23]

To complement the SFDR, the Commission is currently in the process of reviewing the Non-Financial Reporting Directive, in order to shift the focus of financial institutions and companies away from short-term financial performance and expand the scope of the Directive to also oblige listed SMEs to publish non-financial information. Furthermore, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD),[24] which is expected to apply as of 2023. The proposal calls for the audit of reported information and incorporates a requirement to report according to mandatory EU sustainability reporting standards. It also requires that companies make the reported information machine readable to improve access to such information. The obligations enshrined in the proposal cover all large companies and those of smaller size which are listed on regulated markets (some 49,000 companies).

Until the CSRD is applied, disclosures for all those companies that will be subject to the Directive in the future will be governed by the SFDR and the Taxonomy Regulation. The latter in particular will require certain companies to disclose turnover, capital and operating expenditures from products or activities falling under the Taxonomy Regulation, as of January 2022. Indeed, Article 8 of the Taxonomy Regulation requires non-financial undertakings to disclose information about their environmentally sustainable economic activities as a percentage of their turnover, capital expenditure and operating expenditure (key performance indicators or 'KPIs') but did not equally specify such indicators for financial undertakings such as credit institutions, asset managers, investment firms or insurance and reinsurance firms. Through a Delegated Act adopted in July 2021, the Commission filled this gap by specifying the content and presentation of the information to be disclosed by all undertakings and the methodology to comply

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[22] See the European Commission's Climate Delegated Act (Regulation), which establishes technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives, C/2021/2800 final, 4 June 2021 (not yet published in the Official Journal). The Regulation shall apply as of January 2022.

[23] Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector, [2019] OJ L317/1. Importantly, the Regulation introduced disclosure requirements which are additional to the disclosure requirements that apply to financial service suppliers such as those enshrined in AIFMD or Solvency II, or MIFID II.

[24] See Proposal for a Corporate Sustainability Reporting Directive, COM(2021) 189 final, 21 April 2021.

with that disclosure requirement, allowing companies to translate the technical screening criteria of the Climate Delegated Act into quantitative KPIs.[25]

Overall, the NFRD, as amended by the CSRD; the SFDR and the disclosures warranted set out in the Delegated Act supplementing Article 8 of the Taxonomy Regulation constitute the cornerstone of EU's sustainability reporting regime that supports the EU's sustainable finance strategy and contribute to the creation of an ecosystem of sustainable finance tools such as standards, labels that certify compliance and sustainability data, which they are designed to alter the direction of capital in favour of investments that will allow achieving the EU's sustainability tools. As a complement, the Commission brought forward delegated acts under the Markets in Financial Instruments Directive (MIFID II) and the Insurance Distribution Directive (IDD) requiring that investment and insurance advisers take into account the sustainability preferences of their clients.[26] In that regard, financial advisers will have to carefully assess the type and range of financial products that they will recommend to their clients. Furthermore, fiduciary duties are amended in delegated acts for asset management, insurance, reinsurance and investment sectors, to include sustainability risks in the value of investments.[27]

Secondly, the Commission currently works towards the adoption of an EU ecolabelling scheme for retail investment products and a green bond standard. Along with the EU Climate Benchmarks Regulation,[28] such investment-related tools will increase transparency and allow financial market participants to align their investment strategies with the EU's climate objectives. Previously, the Commission's technical expert group on sustainable finance (TEG) proposed the creation of a voluntary EU Green Bond Standard to boost the green bond market and encourage the issuance of and investment in EU green bonds.[29]

The Commission presented its proposal for a voluntary standard on European green bonds in July 2021.[30] When adopted, the standard will allow firms and public authorities, including issuers outside the EU, to use green bonds to raise funds on capital markets to finance large-scale investments that meet high sustainability requirements while catering for investor protection. The Commission's proposal requires that any funded projects by green bonds be aligned with the EU taxonomy; imposes detailed reporting requirements to ensure that the bond proceeds are allocated adequately; provides that an

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[25] See European Commission's Delegated Act (Regulation) supplementing Article 8 of the Taxonomy Regulation, C(2021) 4987 final, 6 July 2021.

[26] See Commission Delegated Regulation (EU) 2017/565, [2017] OJ L87/1; and Commission Delegated Regulation (EU) 2017/2359, [2017] OJ 341/8.

[27] See also European Commission Communication, 'EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal', COM(2021)188 final, 21 April 2021.

[28] Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks, [2019] OJ 317/17.

[29] See EU Technical Expert Group on Sustainable Finance, Report on EU Green Bond Standard, June 2019, available at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-green-bond-standard_en.pdf.

[30] Proposal for a Regulation on European green bonds, COM(2021) 391 final, 6 July 2021.

external reviewer shall check the compliance of European green bonds with the proposed Regulation and the taxonomy; and finally requires that all external reviewers providing services to issuers of European green bonds be registered with and supervised by the European Securities and Markets Authority (ESMA).

Finally, the renewed sustainable development strategy prioritizes the management of climate and environmental risk and the better integration of such risks into the financial system with a view to safeguarding financial stability. In this respect, some adjustments in the current EU prudential framework may be needed, as is an assessment of the adequacy of existing capital requirements for green assets.

Shifting towards a long-term mentality in the financial sector is an objective but also a challenge for the European legislature. Thus, along with the re-orientation of capital flows needed towards sustainable investment, regulatory interventions or private regulation initiatives will have to foster transparency and long-term vision in financial and economic activity while streamlining disclosure standards (for example, in the case of carbon-related environmental risks). In this regard, the EU is expected to use the IPSF to coordinate efforts on the most important areas of sustainable finance, as identified by policymakers, that is, taxonomies, disclosures, standards and labels, but also products, tools and capacity-building. At the external level, the EU also hopes for an upgraded role for the Financial Stability Board (FSB) to cover the contribution of the global financial system to climate- and environment-related objectives.

The EU legislature considers sustainable finance as aiming at the improvement of the contribution of finance to sustainable and inclusive growth by funding society's long-term needs and strengthening financial stability by incorporating ESG factors into investment decision-making. The new Sustainable Finance Strategy adopted by the European Commission in July 2021 is adamant about the climate resilience of the financial sector being dependent on the systematic integration of both financially material sustainability risks (outside-in) and sustainability impacts (inside-out) in financial decision-making processes ('double materiality' concept). Such integration has already started having an impact on the business model of banks and insurers but also of those entities that assess their risk management processes such as credit rating agencies.[31] Associated projects of interest for the financial sector such as the completion of the EU Capital Union will certainly be affected.

XI.104.2 Sustainable financial services and the role of the GATS

Typically, when we talk about the financial sector generally, it is important that we distinguish among, but also incorporate the often-varying characteristics of, banking, securities and insurance. This classification has also been adopted by the General Agreement on Trade in Services, the first multilateral trade agreement on services under the auspices of the World Trade Organization (WTO). This classification at a multilateral level reflects a common understanding among the more than 160 WTO Members that these categories encompass all activities in the financial sector.

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[31] European Commission Communication, 'Strategy for Financing the Transition to a Sustainable Economy', COM(2021)390 final, 6 July 2021.

Paragraph 5(a) of the Financial Services Annex to the GATS defines financial services in a very broad manner to include 'any service of a financial nature'. The illustrative, albeit comprehensive, list included in the Financial Services Annex is another indication of WTO Members' intention to gradually 'multilateralize' access to their financial markets, allowing for regulatory convergence and paving the way for the globalized supply of financial services.

The financial sector includes all banking and other financial services and all insurance and insurance-related services[32] (except services supplied in the exercise of governmental authority such as those relating to monetary policy).[33] Insurance and insurance-related services cover life and non-life insurances, reinsurance, insurance intermediation such as brokerage and agency services, and services auxiliary to insurance such as consultancy and actuarial services. Banking includes all the traditional services provided by banks such as acceptance of deposits, lending of all types, and payment and money transmission services. Other financial services include trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money broking, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services.

Importantly, paragraph 5(a) (viii)–(xvi) of the Financial Services Annex to the GATS also encompasses financial services that are supplied until a financing deal is finalized and which need not be supplied by a banking institution, i.e. an institution that takes deposits. These include payment and money transmission services, trading services, asset management and trust services, settlement and clearing for financial assets, financial information and data processing services, as well as intermediation and other auxiliary services.

In general, more often than not, financial services providers potentially affected by trade-related measures in the financial sector would be credit institutions, brokerage firms, insurance firms and non-bank financial intermediaries, covering a wide range of different activities. In view of the analysis in the previous sections, it becomes abundantly clear that measures adopted by WTO Members could potentially have a chilling effect where they impede access to a given market; impose unreasonable conditions for the launch of innovative financial products, processes and related instruments; impose limitations of a quantitative nature on financial services providers in terms of operations, transactions or asset value; favour in any way domestic providers of financial services to the detriment of foreign providers; apply measures of general application in an arbitrary manner; or fail to abide by the principle of transparency.

Many of these measures adopted by WTO Members could escape scrutiny by the WTO adjudicating bodies if WTO Members have not pledged in their respective Schedule of Services Commitments to act otherwise. Having said this, the WTO Members with the biggest interest in financial services made sweeping commitments during the later 1990s (many of those based on the Understanding on Commitments in Financial Services), which suggests that the regulatory landscape in financial services may not be as fragmented as in other countries which made fewer liberalizing commitments – or no commitments at all.

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[32] See the GATS Financial Services Annex, para. 5.
[33] Ibid., para. 1(b).

Potential deviations from commitments made under a given Schedule of Commitments could in theory be justified under the general exceptions provisions enshrined in Article XIV of the GATS or the prudential carve-out foreseen under paragraph 2(a) of the Financial Services Annex. There are various interpretive issues here that are unsettled for the time being. The first would relate to whether the WTO adjudicating bodies would accept that potentially discriminatory or otherwise trade-restrictive measures relating to the protection of the environment and violating GATS provisions or specific commitments undertaken in financial services can be considered under Article XIV(b). This would rather be answered in the affirmative, although Article XIV(b) does not refer to the protection of the environment, explicitly.[34]

Regarding the prudential carve-out, a critical interpretive issue is whether measures that attempt to promote sustainability in financial services (even if only by discriminating against services that do not or do not in a sufficient manner in the view of the regulating State) could be regarded as taken for prudential reasons. Paragraph 2(a) of the Financial Services refers to some examples of such measures in an illustrative manner: measures taken to protect investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system.

While it may be difficult in theory to connect to the protection of investors or depositors measures taken to induce sustainability in the financial sector, it is argued that such measures could be connected to the objective of ensuring the integrity and stability of the financial system, in view of what we discussed earlier, including the threats that climate change constitute to the resilience of the financial system.

Instead of having recourse to judicial interpretation, WTO Members may also want to opt for a political initiative in the field of financial services and the environment or sustainability more broadly, capitalizing on recent theoretical and sectoral advances on the role, importance and mechanics of ESG factors in finance. Twenty years after the creation of this list incorporated in the Financial Services Annex,[35] one can reasonably argue that the list is gradually becoming outdated. In the area of sustainable finance, the current categorization appears to be utterly inadequate, as it does not reflect contemporary trends and entrepreneurial needs, whilst it allows for the inscription of inherently conflicting commitments in the GATS Schedules of WTO Members.[36] Future negotiations should urgently address these shortcomings with a view to improving market access in emerging services sectors at all possible stages (for instance, the set-up of company activities; distribution; trading services; clearing and settlement; new financial services; auxiliary financial services), allowing for targeted liberalization and improving legal certainty through additional clarity of the applicable regulatory conditions.

WTO Members could also contemplate working on a Decision on trade in sustainable financial services, which could include the following features: express a ‘convergence of mindsets’ with regard to facilitating sustainable finance globally; clarify the objectives

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[34] See Delimatsis and Gargne (2021 forthcoming).

[35] Note that the current financial services classification was already incorporated in the Services Classification List (WTO Doc. MTN.GNS/W/120 of 10 July 1991).

[36] See also Delimatsis (2009), at 451–2.

of WTO Members and thus their commitment to sustainability towards market participants and other stakeholders; call for new commitments by WTO Members on a pre-established set of sectors and sub-sectors (either existing or newly identified) of relevance for sustainable finance; agree on a certification scheme (or an equivalence mechanism) for sustainable financial products; suggest a consultation mechanism for raising concerns about potentially distorting subsidies in the field of sustainable financial services at a minimum;[37] agree on a reporting/notification mechanism and database which will focus on addressing potential greenwashing; and introduce a mechanism for review of that agreement or a mandate for the operationalization of the Decision with more detailed rules. While such a Decision could be extended to cover all services which are regarded as essential for climate change mitigation and adaptation activities, narrowing down the scope to only include financial services in view of their role as a backbone for the economy appears to make sense.

XI.104.3 Conclusion

The financial sector has been an essential intermediary in climate financing and investment, as well as credit risk management.[38] Furthermore, it has been instrumental in the development of new climate risk hedging products. In addition to banks establishing the foundations for resilient financial services, insurance companies have been striving for adaptation to a new reality for many years now. The Association for British Insurers projected that by 2050 the annual cost of weather-related claims (such as storms, floods and other natural disasters) will double to reach €3.3 billion, whereas annual claims during an extreme year could amount to €20 billion. For big global insurers such as Allianz, some 40 per cent of insured losses globally are already due to natural disasters, notably storms and floods.[39]

While sustainable finance can be regarded as an important component of the green transition, its role at present should not be overstated. This is because less than a quarter of industrial emissions come from companies that can be influenced by investors in stock markets. Green-investment-related initiatives may not be able to do much when it comes to the practices of several companies active in the energy and natural resources sectors. In addition, whereas it is estimated that at least $3 trillion of institutional assets are managed in a manner that considers ESG factors, this represents just 4 per cent of total assets under management.[40]

At the same time, the integration of sustainability-related elements in financial decision-making in both public and private financial markets is expected to continue, as even big fossil fuel producing countries are looking for ways to diversity their economy.

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[37] Note that the GATS, unlike in the case of trade in goods under the Agreement on Subsidies and Countervailing Measures (SCM), does not incorporate rules that regulate subsidization in the field of services. It merely calls for negotiations in the area, which however have advanced at a very slow pace during the last twenty years.

[38] Richardson (2009) at 599.

[39] The Allianz Group and WWF, 'Climate Change and the Financial Sector: An Agenda for Action', June 2005.

[40] See The Economist, 'Hotting Up – How Much Can Financiers Do About Climate Change?' (20 June 2020).

A diverse range of larger financial actors such as commercial and development banks, insurers, institutional investors and large private equity firms actively seek to associate their processes with (and benchmark them against) sustainability objectives. The same applies to 'gatekeepers' such as stock exchanges or credit rating agencies, whereby data, product, valuation and risk methodologies gradually integrate into core business offerings.[41]

For the time being, less attention has been dedicated to the potential for a more active involvement of small- and medium-sized enterprises (SMEs) in the area of sustainable finance. Arguably, the involvement of a variety of financial service suppliers of different size and business models which are genuinely focused on innovation and differentiation should be encouraged more than currently is the case. In the present climate, it appears that the financial landscape in the field of sustainability may be too unstable for smaller entrepreneurs working on small-scale projects. Broadening the circle of financiers would offer better levels of liquidity for companies of smaller size active in sustainability-related projects, as well as the diversification of financing opportunities and more development-conducive competition. Therefore, supportive and flexible market structures and a long-term, but adaptive regulatory framework will be conducive to a green and clean revolution, while also meeting the pledge for inclusive recovery in the aftermath of the crisis caused by the pandemic and previously by the Great Recession.

For instance, governments could experiment with lower prudential requirements for sustainable finance providers who are only interested in this market segment. Better supervision, greater transparency (ideally with a standard form of regular disclosures) and regular information exchange channels among supervisors and regulators could substitute for excessive capital requirements applicable to those providers.[42] More generally, as the green finance market is relatively new, governments have every interest in avoiding making the conditions for participating in this market so sophisticated that only the big financial institutions understand and are able to meet the conditions for taking part. Rather, more responsive regulatory frameworks will create more competition and better conditions for financial innovation, driven by new technologies (FinTech) and sophisticated data mining, thus opening up this relatively new market to SMEs. FinTech is already playing a key role in the digital financial transformation and may drive the pursuit of SDGs in the developing world in particular.[43]

In this effort, the WTO can play a role in monitoring good regulatory practices in sustainable finance, but also consolidate regulatory advances at a later stage. Other than increasing fairness in the field of sustainable finance, the constellation proposed above would be in line with the spirit and the objectives of financial inclusion, which aims to improve access to finance, thereby offering opportunities for financial services to small businesses. Financial inclusion, as a key component of SME financing, could soon grow to become an essential part of sustainable finance and thereby enable millions of people to reap the benefits of technology and promote sustainable development. The WTO could also play a role here in offering technical assistance and capacity-building

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41 See UNEP, 'Sustainable Finance Progress Report', March 2019, at 10.
42 See Delimatsis (2011) at 333.
43 See Arner et al. (2020).

programmes in support of developing countries which work on the development and implementation of sustainable finance schemes and maps at the national level.

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