11 August 2020

The New EU Sustainable Finance Model

Introduction

The circular seeks to provide an outline of the legislative instruments that will come into force within the next twelve months and provide information on other initiatives being undertaken at EU level.

An outline of the approach being adopted by the MFSA internally and in conjunction with stakeholders on the implementation of these EU legislative instruments will follow. The current circular is to be considered without prejudice to any possible EU-level changes to the relevant legislative package as well as to forthcoming adoption of EU subsidiary legislation.

The National statutory competence to implement this body of EU legislation will be vested by the MFSA.

Background - EU Legislative Initiatives

At EU level, sustainable finance is a work stream aimed at supporting the European Green Deal by channeling private investment to the transition to climate neutral economy as a complement to public money.

The European Commission has been making headway on its Sustainable Finance Agenda. It has been implementing a range of initiatives to meet its international environmental commitments and targets, from its Action Plan on sustainable finance to the EU Green Deal. These efforts include substantial regulatory changes to help the EU reach its goal of net-zero carbon emissions by 2050 and maintain a stable and sustainable financial system.

The European Commission has achieved significant progress under its Action Plan, with all three main legislative initiatives currently in the process of being implemented. These being:

- Taxonomy Regulation - A political agreement was reached in December 2019, adopted on 22 June 2020 and entered into effect on 12 July 2020. The relevant Regulation establishes the conditions and the framework to create a unified classification system (or taxonomy) on what can be considered environmentally sustainable economic activities. Financial sector actors will likely be motivated to develop their analyses of their investment and financing targets, and to aggregate them in order to define their organization's risks and impacts, as well as to further develop them into a report. The Commission will later establish the detailed Technical Screening Criteria for economic activities through delegated legislation. Where a licence holder performs only environmentally sustainable activities, the investment in this company shall be deemed as an environmentally sustainable asset. Nonetheless, one is to note that the taxonomy regulation encompasses all three factors of sustainability which are governance, social and environmental. Therefore, if a licence holder does not invest in an environmentally sustainable asset, however, applies a social driven policy in the manner in which it operates, such an action may still be considered sustainable. In simpler terms Taxonomy is a classification system, which typically takes the form of a list or table that classifies specific objectives or concepts as sustainable.

- Disclosure Regulation - In December 2019 the Regulation entered into force and will be applicable as of 10 March 2021. The current Regulation introduces obligations on institutional investors and asset managers to disclose how they integrate Environmental, Social and Governance (ESG)[1] factors in their risk processes. The Disclosure Regulation seeks to harmonise existing provisions on disclosures to investors in relation to sustainability-related disclosures by imposing requirements on so-called financial market participants and financial advisers in relation to financial products. In addition, European Supervisory Authorities (ESAs) are developing detailed technical standards to aid the application of the Regulation. Most will be adopted via delegated acts by 30 December 2020;

- Benchmark Regulation - The final text amending the EU Benchmark Regulation ("EU BMR) was published in November 2019. Benchmark administrators, providing new climate benchmarks, will have to comply with the Regulation by 30 April 2020. The aim of the legislation is to ensure the reliability of benchmarks and minimize conflicts of interest in benchmark-setting processes. EU BMR builds on the IOSCO principles for financial benchmarks and applies to any benchmark used within the EU. EU BMR will affect all published indices 'used' in the EU in financial instruments and contracts or by fund managers. ESAs are now working on the delegated acts that would specify in more detail the Regulation requirements and which are expected to largely be based on the recommendations by the Commission's Technical Expert Group published in September 2019. These acts set out the ESG disclosure requirements in relation to benchmark statements and benchmark methodologies and the minimum standards required for the new "Climate Transition Benchmarks" and "Paris-aligned Benchmarks". These benchmarks will allow a significant level of comparability of climate benchmarks methodologies while leaving benchmarks' administrators with an important level of flexibility in designing their methodologies. The establishment of EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks, underpinned by a methodology linked to the commitments laid down in the Paris Agreement regarding carbon emissions, would contribute to increasing transparency and would help prevent greenwashing. In the absence of a harmonised framework to ensure the accuracy and integrity of the main categories of low-carbon benchmarks used in individual or collective investment portfolios, it is likely that differences in Member States' approaches will create obstacles to the smooth functioning of the internal market

Moreover, the European Commission is now planning to publish an updated sustainable finance strategy in Q3 2020 ("Renewed Sustainable Finance Action Plan"). The strategy will build on the 2018 Action Plan and is expected to include the integration of ESG factors in corporate governance and the

[1] Sustainable finance generally refers to the process of taking due account of environmental and social considerations when making investment decisions, leading to increased investment in longer-term and sustainable activities. More specifically, environmental considerations refer to climate change mitigation and adaptation, as well as the environment more broadly and the related risks (e.g. natural disasters). Social considerations may refer to issues of inequality, inclusiveness, labour relations, investment in human capital and communities. The governance of public and private institutions, including management structures, employee relations and executive remuneration, plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process. All three components – environmental, social and governance (ESG) – are integral parts of sustainable economic development and finance.

development of labels for retail investment products, amongst other proposals. On 8 April 2020, the European Commission launched a consultation on the sustainable finance strategy. The MFSA actively participated and submitted its views.

As part of its efforts to increase transparency in sustainability reporting and enhance the availability of ESG information the Commission is taking steps to review the Non-financial reporting Directive (NFRD), the EU law laying down the rules on disclosure of non-financial and diversity information by large companies, including how they integrate ESG factors in their strategies and manage social and environmental risks. To this effect, on the 20 February 2020 the Commission launched a public consultation on the review of the NFRD, and which the MFSA participated in. The Commission indicated the first quarter of 2021 as target delivery date.

On 1 June 2020, the European Commission published FAQs on the work of the European Commission and the Technical Expert Group on Sustainable Finance on the EU Taxonomy and EU Green Bond Standard. The focus of the FAQs is on the final reports of the Technical Expert Group on Sustainable Finance on the EU Taxonomy and the EU Green Bond Standard, as well as on how the Commission intends to take the content of those reports forward.

Approach being adopted by MFSA and next steps

The roadmap presents the need for adjustments and potential opportunities for the whole investment chain. The MFSA as a competent authority intends to work closely with regulated entities and financial market practitioners to prepare for the EU's forthcoming regulatory changes. In this respect the MFSA will be consulting in general and specifically with respect to sectors, prior to legal obligations enter into force.

The MFSA has commenced its work on the implementation side and is examining the impact of the proposed changes to the local financial services' sectors. The way the Authority intends to go about it are twofold:

1. Increasing awareness and assessing impact of legal requirements:

Separate informative circulars will be issued for different legislative instruments, and consultations conducted. The first consultation dealing with the EU BMR has already been conducted. The Securities and Markets Supervision (SMS) Function issued a questionnaire to all entities supervised by the MFSA in relation to the EU BMR to gauge usage of Green Benchmarks and New Benchmarks. SMS has assessed the responses received from the local licence holders' perspective and it transpires that currently there is limited use of Green and New Benchmarks.

On a similar note, with respect to the Disclosure Regulation, the MFSA will be issuing a separate circular about the requirements emanating from this Regulation and related to it the Taxonomy Regulation.

The MFSA is also analysing Sustainable Finance from a financial stability perspective. In this regard, the Financial Stability Function is currently conducting a project meant to analyse climate risks implications for the stability of the Maltese financial System. A preliminary assessment [2]quantifying domestic institutions' exposure to climate policy relevant sectors (CPRS) has been recently finalised and presented internally. In the coming months a few additional initiatives are planned, aimed to broaden further the analysis, incorporating elements such as interconnectedness across financial institutions. In addition, in order to further develop expertise on the topic of climate change and sustainable finance and the implications for financial stability, the MFSA became member of Network for Greening the Financial System (NGFS), specifically, in relation to a Macro Financial workstream. The Financial Stability Function is closely following the Network's ongoing work in view of applying the developed methodologies to the Maltese context, particularly in relation to a climate stress testing exercise. Finally, with the purpose of gaining knowledge on climate risk metrics and statistics, the MFSA became a member of the ATC /FSC Project Team[3] on Climate Risk Monitoring.

2. Implementing and facilitating compliance by licence holders:

The MFSA is encouraging the market to familiarise and acquaint itself with the requirements in particular with the Disclosure Regulation, which will apply to all regulated entities. It is expected that the industry plans for the updates of its internal policies accordingly in order to conform with the regulation.

The MFSA will focus its implementation work and compliance approach while underlining the need for consistency, coherence and setting the right founding elements for such an important shift in finance which is bound to be long term. The MFSA would seek to avoid a fragmented approach by different sectors and entities. It is our utmost intention to facilitate the transition in a way at that minimises any potential negative impact.

Looking ahead, the MFSA looks forward positively and aims to increase awareness on sustainable finance amongst the entities under its supervision to ensure compliance. In the coming months, the MFSA will delve deeper into the subject matter from a regulatory perspective and will take the opportunity to inform the market of the amendments pertaining to the prudential rules. In this regard, the MFSA will be consulting with all relevant stakeholders before seeking to implement the relevant EU legislation in line with the requirements of the local market.

[2] This is the first quantitative investigation based on a methodology developed by S. Battiston et al.

[3] A joint task force comprised of the European Systematic Risk Board's Advisory Technical Committee (ATC) and the European Central Bank's Financial Stability Committee (FSC).