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How sustainable is the EU's sustainable finance regulation?

A €2.5trn question?

A

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How sustainable is EU's sustainable finance? Our synopsis.

'We estimate an increase in operating costs arising from the EU’s sustainable finance programme to be greater than €30bn and destroying potentially €2½trn of capital by the net zero date of 2050 in the process.'

This paper queries the regulatory rationale and cost of broader sustainable finance regulation of the type implemented by the EU. We believe that focussing on a singular objective of climate change mitigation is a preferable route.

Task Force on Climate Related Financial Disclosures (TCFD) align finance sector policy more closely with legitimate policy objectives and regulatory mandates. We also believe that it is a sufficient general proxy for sustainability.

We estimate an increase in operating costs arising from the EU’s sustainable finance programme to be greater than €30bn and destroying potentially €2½trn of capital by the net zero date of 2050 in the process. Capital that is better deployed bridging the investment gap to meet IPCC climate change targets.

We calculate these figures based on previously published estimates and the European Commission’s own published analysis which demonstrates that new regulations increased industry costs in the EU by more than 10% over the past decade.

This rationale justifies the regulatory divergence committed to by the UK: a commitment to incorporation of TCFD.

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Introduction

'We believe in TCFD and that TCFD reporting can serve as a sensible, less expensive, proxy for general sustainability issues.'

If one was to believe social media, sustainability has become the primary rationale for all investment in the 2020s. Significant claims are made impact of sustainable finance and ESG. Claims that some dispute.

Given the speed of transformation of the investment landscape, together with the huge advisory industry that has appeared almost overnight, there are major concerns for 'green-washing' in the sector and it is not surprising that regulators have sought to act.

But our view is that there is a significant difference between the rationale for the risk related disclosures of TCFD reporting and the rationale for broader ESG type reporting. A distinction that is rarely presented or discussed which we attempt to do in this paper.

We have concerns with the costs of the EU's regulatory approach to sustainable finance. We do not believe the burden or the benefits of another layer of ESG type reporting requirements have been properly considered. No economic impact was produced, instead an a priori assumption that harmonisation creates efficiency together with a regulatory mandate for harmonisation has been relied upon.

We estimate in this study that the reporting requirements will increase costs by more than €30bn and as much as €2½ trillion in capital could be destroyed by 2050, the net zero target. Capital that could have been more usefully deployed to climate finance.

'The finance sector has still to fully absorb the significantly higher costs of the increased regulatory burden of the last decade and is now having to come to terms with a very different and inflationary investment outlook.'

The finance sector has still to fully absorb the significantly higher costs of the increased regulatory burden of the last decade and is now having to come to terms with a very different and inflationary investment outlook.

We believe that TCFD reporting can serve as a sensible proxy for general sustainability issues. With much less complexity. We believe that expensive requirements for ESG type reporting of variables of ambiguous value risks undermining the cause of climate finance.

We believe that this view informs the UK's divergent approach from the EU with its concentration on core TCFD disclosures, a more proportionate and cost-effective approach in our view. One we believe is also more consistent with policy goals and regulatory mandates.

Rehabilitating finance.

"Sustainable finance will provide a vital underpinning for a needed green transition, supporting ambitious climate-related and environmental goals both within the European Union (EU), and beyond its borders. Indeed, the European Commission's Sustainable Finance Strategy notes the key role for the financial sector in this 'green' transition, by bringing together supply and demand for 'green' capital, thereby supporting sustainable finance."

Sustainable Finance in the EU
HIEBERT P. & VANSTEENKISTE I.
College of Europe, Bruge

> "asset managers continue to repurpose and rebrand conventional [fund] products into sustainable offerings".

Sustainable Finance has helped transform the reputation of the sector. This remark is a far cry from the comment that much of what goes on in the financial sector was 'socially useless' by Adair Turner (former head of the UK's FSA) in 2009. The perception of the finance sector has been transformed since the global financial crisis, certainly amongst EU policy makers. More than a decade later, European policy makers insist that the finance sector has a central role to play in meeting climate and environmental objectives.

Notwithstanding that much capital has been deployed to the cause of the UN's IPCC objectives and Sustainable Development Goals through 'sustainable finance' there is no doubt also that the issue has been deliberately exploited to help rehabilitate the public standing of finance sector. But we believe it has gone too far.

After two years of lockdown, it is difficult to recall that it was as recently as 2019 that climate finance 'took centre stage'. That was the year of Extinction Rebellion in the UK and Greta Thunberg worldwide. Now it is almost impossible to avoid ESG marketing on social and indeed traditional media.

Combined with virtue signalling, we believe this has led to an absence of critical analysis of the legitimacy, credibility, cost and benefit of much of the measures accompanying 'sustainable finance', regulatory or otherwise. We believe this explains why no attempt was made to assess the costs of the Sustainable Finance Disclosure Regulation (SFDR) by the European Union. A concerning development in principle as well as practice.

According to US research firm Opimas, the value of global assets applying environmental, social and governance data to drive investment decisions tripled in the eight years to 2020, to $40.5 trillion. But Morningstar, the financial services data provider, comment that "asset managers continue to repurpose and rebrand conventional [fund] products into sustainable offerings" does not instil confidence.

Commenting on the prospects for the sustainable bond markets, Standard and Poors, made the following observation "we believe the sustainability-linked bond market has substantial headroom for growth…..Because proceeds are typically not ring-fenced for specific environmental or social projects, sustainability-linked instruments have proven more flexible and accessible than use of proceeds instruments for a variety of issuers."

Hardly reassuring to those for whom ESG washing in particular is a concern and perhaps providing a case for tighter disclosure regulation.

ESG: delivering greater returns or complexity?

ESG integration, commenters explain, is the consideration of ESG factors as part of prudent risk management and a strategy to take investment actions aimed at responding to those risks (whereas economically targeted investing, by comparison, is investing with the aim to provide financial as well as collateral, non-financial benefits).

The World Economic Forum explains that ESG is merely the consideration of ‘ESG factors’ as part of prudent risk management and strategy. But creating a global consensus on which factors might pose the appropriate representative set has proven to be problematic, despite many attempts by many organisations. There is a reason why international financial supervisory bodies keep clear of defining such variables. For even the European Commission, results are still very much ‘work in progress’. Unlike climate change where greenhouse gas emissions form the core comparable parameter that can be readily transposed into straightforward, verifiable, comparable metrics, no such simplicity exists for ESG. There is no common, standard set of variables that can be clearly demonstrated to be representative of all ESG factors. Without which standardisation of ESG practice is not possible. Only cursory armchair analysis is necessary before one leads quickly to the conclusion that the degree of complication of this exercise does not make this a cost-effective approach.

Whether it is desirable is another matter. Even given a presumption that there are multiple variables which may provide a reliable measure of an ambiguous concept of sustainability does not lead to the conclusion that a prescriptive, mandatory approach to these matters is sensible or desirable. Yet in 2021 the US think thank, Influence Map, reported more than 70% of ESG equity funds it had assessed were not aligned with Paris targets. We suggest simple measures not ambiguous concepts are the better measure.

Bloomberg suggests that by 2025, a third of all investment funds will be managed according to an ESG mandate. Which implies little differentiation. Nevertheless, this has not prevented researchers from seeking to attribute better financial performance to those that follow the ESG approach.

In an comprehensive work, researchers from NYU and Stern published a study on the relationship between ESG and financial performance after examining 1000 plus individual studies.

It arrived at the following conclusions:

ESG integration, broadly speaking as an investment strategy, seems to perform better than negative screening approaches.

ESG investing appears to provide downside protection, especially during a social or economic crisis.

Sustainability initiatives at corporations appear to drive better financial performance due to mediating factors such as improved risk management and more innovation.

Studies indicate that managing for a low carbon future improves financial performance.

ESG disclosure on its own does not drive financial performance.

These conclusions suggest a potentially positive relationship, but it did not derive definitive conclusions. Proven causality and relationships of statistically significance were absent. Unsurprisingly therefore, language is deliberately guarded: ‘ESG integration *seems* to perform better’; ‘ESG investing *appears* to provide downside protection’; ‘Sustainability initiatives *appear* to drive better financial performance’.

An alternative explanatory narrative could be that managers that take a broader assessment of risk, ceteris paribis, tend to generally achieve better returns. This would suggest that investors would be advised to seek out such managers, but it would not provide compelling evidence to prescribe by legislation which particular ‘sustainability risks’ should be assessed by such managers nor indeed how such an esoteric objective must be measured.

Until the Trump Administration sought their reverse, ithe changes the US had made to the rules of interpretation of fiduciary duty were little registered elsewhere. This being in response to another United Nations initiative 'Fiduciary Duty in the 21st Century' (again fronted by Vice President Al Gore).

An interesting concept, the UN perspective is that fiduciary duty is an all-encompassing concept and that consideration of ESG type factors during investment decisions is a necessary condition in the exercise of proper fiduciary duty. Policy makers, particularly those in civil jurisdictions had little compunction with seeking to make consideration of such factors mandatory through regulations.

‘Sustainable investing (or, as some call it, responsible investing) isn’t anything new, but it has undergone some evolution. What started a few decades ago as a somewhat basic ethical assessment of business activity has matured into a more thorough integration of environmental, social and governance (or, ESG) factors via quantitative and qualitative assessments.’

World Economic Forum

ERISA

‘Paragraph (c)(1) of the proposed rule required that a fiduciary's evaluation of an investment be focused only on pecuniary factors. The proposal expressly provided that it is unlawful for a fiduciary to sacrifice return or accept additional risk to promote a public policy, political, or any other non-pecuniary goal. Paragraph (c)(1) also expressly acknowledged that ESG factors and other similar considerations may be pecuniary factors and economic considerations, but only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The proposal emphasized that such factors, if determined to be pecuniary, must be considered alongside other relevant economic factors to evaluate the risk and return profiles of alternative investments. The proposal further provided that the weight given to pecuniary ESG factors should reflect a prudent assessment of their impact on risk and return—that is, they cannot be disproportionately weighted. The proposal also emphasized that fiduciaries' consideration of ESG factors must be focused on their potential pecuniary elements by requiring fiduciaries to examine the level of diversification, degree of liquidity, and the potential risk-return profile of the investment in comparison with available alternative investments that would play a similar role in their plans' portfolios.’

Though several common law jurisdictions where fiduciary duty has strong groundings in jurisprudence such as the UK took a more considered approach. The UK Pensions Regulator taking several years of deliberation before incorporating requirements. It is instructive that the UK's FCA has pivoted to a principles-based application for ESG disclosure requirements. Principles which are essentially ‘be honest and clear’. A clear divergence from the approach of the EU.

In the US, as would be expected, the approach of the Trump administration to ‘reversing’ the amendments of the previous Democratic administration was the source of much public debate and controversy. But attempting to view the wording agnostically today, does give pause to the grounds of much of the criticism.

We believe that consideration of ESG type risks is a practice to be encouraged particularly if such risks may have a material impact on future pricing.

The wording of the ERISA amendment supports this approach; indeed we suggest it encourages this approach as the clear inference is that if risks have potential pecuniary impact they must be considered.

We believe it is hard to find fault with this reasoning. It is entirely consistent with the proposal that ESG is an approach that can enhance returns. What it does not do is enable pension fund trustees to follow other objectives as a substitute for returns. Indeed, incorporation of multiple objectives for fiduciaries is a recipe for confusion. However, we believe that mandatory TCFD reporting can serve as a reasonable proxy for general sustainability issues. With much less complexity. We believe that expensive requirements for ESG type reporting of variables of ambiguous value risks undermining the cause of finance.This really is a matter for public policy. If governments have public policy objectives, they must use the correct instrument for the purpose.

Climate risks and the rationale for metrics

'One of the most significant, and perhaps most misunderstood, risks that organizations face today relates to climate change…. The large-scale and long-term nature of the problem makes it uniquely challenging, especially in the context of economic decision making…..Creditors and investors are increasingly demanding access to risk information that is consistent, comparable, reliable, and clear.'

Final report, 2017, Task Force on Climate Related Financial Disclosures (TCFD)

'Financial regulators have a legitimate claim on prudential grounds to require financial firms take account of such risks [climate] within their business strategy.'

TCFD | TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

Global regulators deem climate risk an existential threat to financial stability. But climate risk is not just an existential future risk, it is an immediate threat to current business strategies once future risks are assessed, discounted and priced-in to current values.

For these reasons, financial regulators have a legitimate claim on prudential grounds to require financial firms take account of such risks within their business strategy.

The TCFD provided a set of recommendations regarding climate-related financial disclosures. It set out four key recommendations covering governance; metrics and targets; strategy; and risk management, to be followed by an organisation.

Each recommendation including associated and specific recommendations for disclosure.

On strategy, the TCFD recommended the disclosure of the considered actual and potential impacts of climate-related risks and opportunities on a organisation's businesses, strategy, and financial planning where such information was material.

On metrics, it recommended the disclosure of the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

Risks that might impact on price are clearly material. The TCFD states that the asset owners should disclose the appropriate financed emissions metric. These appropriate metrics have now been developed by bodies such as the Partnership for Carbon Accounting Financials.

In short reporting is a good thing. It encourages robust assessment which leads to better pricing. Markets discount the future. Climate risk needs to be priced in now as it is a real and present danger to valuations and business strategies. Transparent TCFD disclosures are in our opinion the route to a better and fuller understanding of climate risk, and importantly, its pricing.

Once provided as guidance, the international regulatory world has been busy rolling out mandatory reporting requirements. The formation of the new International Sustainability Standards Board was announced ahead of CoP26 in 2021. Its stated goal to develop a set of international reporting standard based on TCFD.

The UK has been at the forefront of transposing TFCD into regulatory requirements. First applied to bank and insurers, coverage now extends to fund managers, pension funds, insurers as well as listed companies.

The diverging paths of sustainability regulations: EU

The European sustainable finance legislative programme is a legacy of the Capital Markets Union (CMU) initiative of the last UK European Commissioner, Sir Jonathan Hill. The goal of the CMU was to create a single capital market across the EU and as such it is unsurprising to see harmonisation being the key focus of the sustainable legislative programme.

The EU has established a comprehensive three pillar legislative framework for the creation of its sustainable finance architecture: Taxonomy, Disclosure Regulations and Benchmarks. Similar to much of its regulatory strategy, the EU made it quite clear that its ambition was to become the international standard setter for sustainable finance. It has no qualms about the scale of its legislative architecture.

At the foundation of the EU's architecture is the Taxonomy, a classification system that determines whether an economic activity is regarded as sustainable and consistent with any of six environmental objectives. Once hailed as creating a single global system it has become mired in controversy with the inclusion of nuclear and gas because of lobbying from Member States. Nonetheless the Taxonomy provides a comprehensive, many say too comprehensive, methodology for classifying differing types of economic activity.

Building on the Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR) has become the central plank of the EU's strategy, setting out disclosure requirements for funds, fund groups and financial advisers. The explanatory rationale for the SFDR given by the European Commission gives as much if not more weight to standardising disclosure requirements as it does to the prevention of 'greenwashing'. A point of significance since it is the harmonisation mandate that has been employed to justify the implementation of the legislative programme.

The SFDR sets out ESG disclosure rules for fund groups, pension providers, discretionary fund managers, financial advisers, and other financial services organisations with operations across the European Union. These disclosures need to be pre-contractual and shown in the prospectus and on websites, and then need to be reviewed periodically thereafter in annual reports.

But the SFDR was indeed innovative as it introduced two new concepts: principle adverse impacts (i.e. the impact a company has on its environment) and entity-level reporting. This comes in addition to the traditional sustainability risks (i.e. the impact the (changing) environment has on a company) and product-level reporting. The SFDR requires financial entities to disclose how they consider the principal adverse impacts of investment decisions on sustainability factors. The SFDR requirements are linked with those under the EU Taxonomy by including 'environmentally sustainable economic activities' as defined by the Taxonomy Regulation in the definition of 'sustainable investments' in the SFDR. Adverse impact reporting is mandatory for financial entities with more than 500 employees, with a comply-or-explain policy for those employing fewer people.

The content, methodologies and presentation of entity level principal adverse impacts has been one of the most discussed topics because of the high implementation cost and the lack of reliable data from investee companies. The initial set of mandatory indicators was reduced from 32 to 18 with 46 opt-in indicators now subject to a materiality assessment. No cost assessments were undertaken by the ESAs (despite a requirement) on the basis that efficiency would result from harmonisation and therefore any impact exercise was redundant. An assessment of cost is a contribution of this paper.

At a product level, traditional (non-ESG) funds also need to explain how they integrate sustainability risks into their investment decisions or, if they don't, to explain why not. The disclosure requirements for ESG funds depend on whether they promote environmental or social characteristics or whether they have sustainable investment as an objective, with those coming under this latter category often known as impact funds.

Although the SFDR is not about classification, the industry has already effectively adopted it as a labelling scheme, with traditional funds being classified as "Article 6", those that promote environmental or social characteristics as "Article 8", and those with sustainable investment as an objective as "Article 9".

On the assumption that investors, when asked, will want at least a degree of sustainability in their portfolio, there has been a drive towards funds being classified as Article 8 or 9, which has in turn led to a backlash from several regulators, highlighting a mismatch between what is said and what is done, and raising concerns about greenwashing. ESMA have also sought to amend the requirements of Article 8 and 9 funds to include greater environmental requirements. Originally, due to come into force in early 2021, the adoption of the RTS has been delayed twice with current plans for them to come into force in 2023. These requirements are being concurrently transposed across into AIFMD and hardwired into MIFID II.

> "The Sustainable Finance Disclosure Regulation (SFDR) has become the central plank of the EU's strategy"

The SFDR's labelling regime

Article 6 funds
funds which are not promoted as having ESG factors or objectives

Article 8 funds
funds that promote ESG characteristics but do not have it as the overarching

Article 9 funds
funds which specifically have sustainable goals as their objective

The diverging paths of sustainability regulations: UK

In June, 2020, John Glen MP, Economic Secretary to the Treasury, made it very clear that the UK government did not intend to implement the level 2 requirements of the SFDR: a move accompanied by protests from UK trade groups.

This signalling of divergence has been followed up with the clear commitment to align with the Task Force on Climate-Related Financial Disclosures (TCFD) and the work of the International Sustainable Standards Board. A move looking more sound with every round of costly delay of the SFDR implementation.

Whilst the UK has signalled a desire to "match the ambitions" of the SFDR, it is very clear that the UK is focussed on climate, happy for now to leave the industry to follow softer principles-based guidance on the broader ESG agenda. The DG of the FCA sending a 'Dear Chair' letter in the summer of 2021 stating as much. The Hong Kong's SFC, whose DG is the current chair of IOSCO, has signalled it will be following a similar route. It would indeed be a surprise if the approach of these two regulators was inconsistent with the forthcoming IOSCO guidance.

The UK also plans to develop its own UK Green Taxonomy which will be closely aligned with the standards of the newly formed International Sustainable Standards Board (which will closely follow TCFD requirements). The UK is taking a more principles-based approach to its own SDR regulation, rather than the EU's preferred rules-based approach that sets out every box that needs to be ticked. The objective being, the FCA says, the aim to enable investors to make considered choices while also being proportionate.

In structure similar to the SFDR, the FCA has set out disclosures at the entity level and product/fund level. At the entity level, firms will need to report how they take climate-related risks and opportunities into account on behalf of their client assets, including governance, strategy, risk management, metrics and targets. But this is far away from the PAI bureaucracy of the SFDR.

Product-level disclosure consists of a baseline set of mandatory carbon emission and carbon intensity metrics, and any governance, strategy or risk measures that differ from the entity-level disclosure.

Product-level metrics include the core metrics of greenhouse gas emissions, total carbon emissions, the carbon footprint and weighted average carbon intensity. In addition to these reporting requirements, firms must carry out regular scenario analysis at both entity and product level to test their portfolios against different climate issues.

Implementation of the FCA's plans will be phased, with asset managers of over £50bn and asset owners with over £25bn being caught in the first phase starting on 1 January 2022, with the first publication deadline being 30 June 2023. The second phase, for smaller firms with over £5bn of assets, comes in on 1 January 2023, with reporting due by 30 June 2024. According to the FCA, requirements will apply to asset managers and asset owners covering 98% of assets managed or held in the UK.

The UK has a separate regulatory regime for trust-based pensions schemes overseen by The Pensions Regulator. The requirements on these types of schemes have arguably moved faster. The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 came into effect on 1 October for schemes with over £5bn of assets. Schemes with between £1bn and £5bn need to comply from 1 October 2022. Reports need to be issued within seven months after the end of the scheme year, with the first one relating to the scheme year ending after each of these dates.

The reporting requirements follow much the same path as the FCA's proposals for asset managers and asset owners, in that they must identify climate-related risks and opportunities likely to affect the scheme's investment strategy over the short, medium, and long term. Trustees also need to assess and disclose the potential impacts and resilience of their scheme's assets in at least two climate scenarios, one of which is based on a temperature rise of between 1.5°C and 2°C (in line with the goals of the Paris Agreement). This scenario analysis may be qualitative and/or quantitative.

'the UK is focussed on climate, happy for now to leave the industry to follow softer principles-based guidance on the broader ESG agenda'

A rationale for divergence?

"The financial crisis of 2007-2008 was an important reminder of the repercussions that weak corporate governance and risk management practices can have on asset values. This has resulted in increased demand for transparency from organizations on their governance structures, strategies, and risk management practices. Without the right information, investors, for example, may incorrectly price or value assets, leading to a misallocation of capital."

Executive Summary, TCFD Final Recommendations

"The Task Force's recommendations are intended to help build consideration of the effects of climate change into routine business and financial decisions, and their adoption can help companies demonstrate responsibility and foresight. Better disclosure will lead to more informed and more efficient allocation of capital, and help facilitate the transition to a more sustainable, lower-carbon economy."

Michael R. Bloomberg, Chair, TCFD,2020 Status Report, September 22, 2020

Disclosure of TCFD metrics provides for greater transparency of both prudential and conduct risks. As well as cost considerations there is the strength of clear golden thread linking policy mandate, objective and regulatory action with measures implementing TCFD. Through the UN's CoP process global commitments have been made by governments across the world on climate change, the TCFD guidance being a product of the G20 and their finance ministries.

Under legally binding treaty, 193 parties have agreed to limit global warming to well below 2C, and preferably to 1.5C, compared with pre-industrial levels. The CoP 21 Paris goals. At last years, COP26 climate summit in Glasgow, signatories committed to setting new greenhouse gas emissions targets by the end of 2020, to meet the Paris goals. While the Paris accord is technically binding on nations rather than individual companies, Allen & Overy, the global law firm, say that there are already signs that it is being interpreted by judges as the standard that companies must adhere to. They cite a landmark ruling in 2021 when a court in The Hague referred to the Paris agreement when ruling that Shell had to make greater cuts to its emissions targets than it had planned. There is currently a similar action in Switzerland against Credit Suisse brought by an investor group.

We believe that mandatory TCFD reporting can thus serve as a reasonable proxy for general sustainability issues. With much less complexity. We believe that expensive requirements for ESG type reporting of variables of ambiguous value risks undermining the cause of climate finance and in our view the UK is taking the better course with its focus on incorporating TCFD requirements.

Growing costs of regulation

Compliance costs are the deadweight loss of regulation; they drive a wedge between capital and its return. Some loss of return is the acceptable price of regulation for stable and functioning capital markets. But some point the level becomes economically unjustifiable.

The costs of compliance for financial services firms have increased significantly during the 21st century, particularly in Europe. We look at it from the perspective of there having been three 'waves' of new regulations.

1. The wave of AML regulations relating to the due diligence and client onboarding that was catalysed by the extension of the mandate of the FATF to include terrorist financing post 9/11.

2. The wave of new prudential requirements, generally increased capital requirements for banks and insurers, in the immediate aftermath of the global financial crisis as the regulatory community sought to ensure the future stability of the financial system.

3. The wave of single rulebook regulation, generally consisting of conduct rules and across the investment sector, that arose following the Lisbon treaty, given impetus by the EU supervisory architecture put in place after the global financial crisis.

It is the first and third of these waves that have in our view had the most impact on the operational efficiency of the finance sector creating a costly bureaucratic compliance culture in the process.

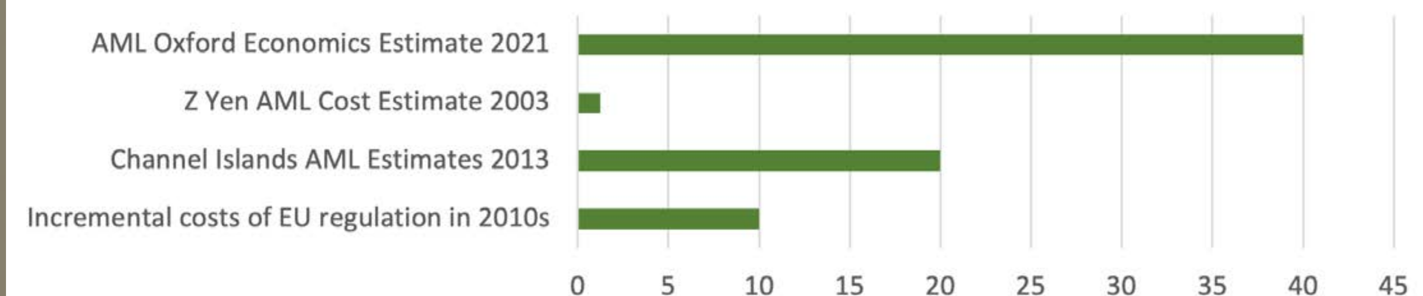
The costs of AML have been the subject of regular criticism. As early as 2005, the financial services think tank Z Yen reported concern about the rise of the growing costs of AML, with costs in the region of 0.1% of GDP. Estimates by KPMG reporting shortly after the financial crisis were of AML costs were rising at that time at a rate of more than 50% per annum.

More recent estimates have put the figures at a significantly greater scale. A study by Oxford Economics in 2021 estimated that the UK's finance sector spending was some £28bn. A figure that some might view as high as this implies that around 40% of all operational costs can be attributed to AML.

But research from the Channel Islands, global leaders in the application of AML, estimated the figure to be around 15% of operational costs in mid 2013 with estimates that AML accounted for 80% of all compliance costs.

The passage of time, the introduction of higher standards in the interim, does suggest that AML costs easily absorb between 20 and 30% of operational costs in the Channel Islands today.

"The costs of compliance for financial services firms have increased significantly during the 21st century, particularly in Europe. "



Growing costs of EU regulation

Whilst the Lisbon Treaty created the single market for financial services in 2003, the accompanying regulatory wave didn't properly hit until after the global financial crisis and the creation of the new European regulatory architecture. By its own estimates, the European Commission introduced regulations in the 2010s that increased the operating cost base of the finance sector by more than 10%: €37bn aggregate ongoing incremental costs.

There is a legislative requirement on the European Commission to demonstrate the economic case for new regulations. This gives us some measure of their tendency to underestimate their cost. We can see from the Commission Staff Working Paper Impact Assessment on MIFID, that original estimates of one-off costs of €622m were some 20 times less than the actual figure of €12bn. Such a ratio is at the higher end of errors, the range of 3-6 times is typical. Viewed by sector, the impact of the MIFID estimates inflates the ratio of actual to estimated rincrease in egulatory costs to 10.

We can find little evidence of concern demonstrated by policy makers with either the scale of the costs or the scale of error of the estimates.

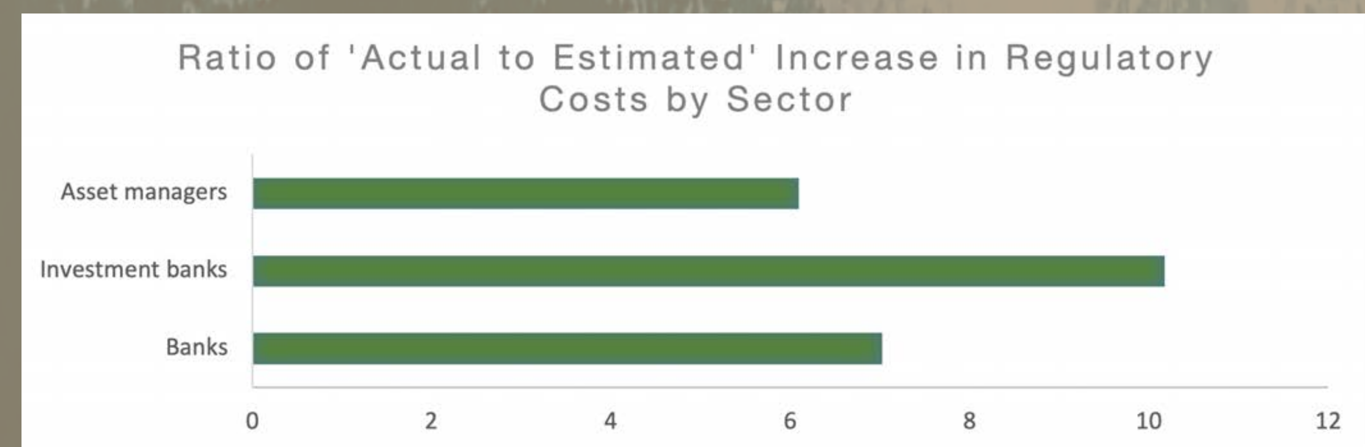
These figures demonstrate to us that the prevailing tendency of harmonisation, rather than increasing efficiency through a single rulebook as intended, is to increase costs. This is a far from innocuous situation. Layer upon layer of regulatory burden incrementally increases the cost of capital of the EU's finance sector. This is an issue rarely discussed at a senior level in EU policy circles, we believe a reflection of the 'consensus' nature of the European policy debate where minority opinions receive little attention.

The single market in financial services sought to benefit the consumer through increased choice and lower prices through increased competition. Our view is that the creation of the single rulebook has been to increase costs in the name of harmonisation and reduce competition through increased regulatory barriers to entry. Certainly, we are aware of no studies demonstrating any increased consumer surplus because of the single market in financial services.

This drift upwards in the cost of the EU's regulatory regime received little airtime over the last decade. The constant change of European regulations has been the source of much fees for lawyers, management consultants and other advisory firms. There has been little cause for many stakeholders to demur. According to the review of regulatory costs published by Centre for European Policy Studies in 2019, legal and consultancy fees typically constitute the largest component of spending after IT, of around 30%, of new regulatory implementation costs.

The EU has increased the cost base of its finance sector by some 10% in little more than a decade purely through the regulatory intervention. This ought to be the matter of concern and policy discussion. An obvious economic loss has developed by stealth. Was a ten percent increase justified in policy terms? Cost considerations would provide a sound rationale on their own merits for the UK to seek regulatory divergence from the EU, irrespective of any competitiveness gains, in the field of sustainable finance. However, the UK's divergence is as much if not more based on policy grounds with the understanding that it is TCFD reporting that is the route to improved prudential and conduct supervisory outcomes.

"By its own estimates, the European Commission introduced regulations in the 2010s that increased the operating cost base of the finance sector by more than 10%: €37bn aggregate ongoing incremental costs."



Costing the EU's sustainable finance regulations

“This initiative will increase transparency and lead to a more consistent treatment of sustainability factors over sectors. It will also reduce search costs for end-investors and ensure that they can better assess the sustainability aspects of their investment decisions.”

Likely Economic Impact

Preliminary Assessment of Expected Impacts

Institutional investors' and asset managers' duties regarding sustainability

Inception Impact Assessment

European Commission, 2017

An a priori assumption that harmonisation creates efficiency together with a regulatory mandate for harmonisation has been the rationale driving the development of the SFDR.

We believe it is important to consider the costs of the EU’s sustainable finance programme. To give pause to the scale of cost, and whether it is necessary and justified in the pursuit of the UN’s climate goals. The EU approach it is somewhat more complicated than a pragmatic and proportionate incorporation of TCFD reporting, as is the route being following in the UK, creating a whole new layer of bureaucratic complexity for the EU’s finance sector, in the name of what we describe as ambiguous sustainability goals.

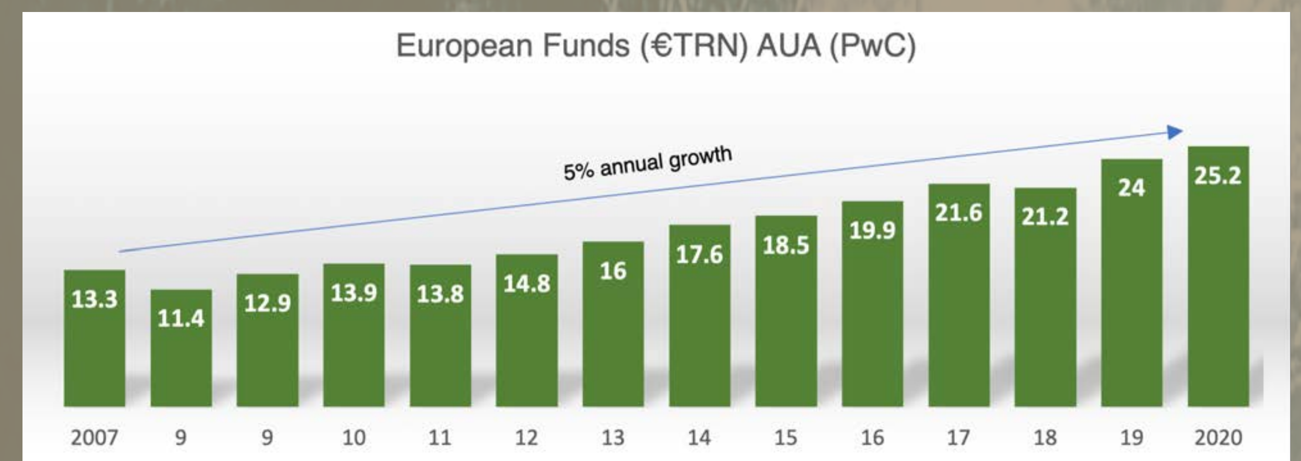
The EU has exhibited all its tendencies towards prescriptive granular detail. The SFDR is at its most basic level a set of disclosure rules. Disclosure rules that go far beyond we believe what is needed to incorporate TCFD reporting across Europe. Is there really a pressing need for a financial entity to assess and disclose the principle adverse impact of its violations of UN Global Compact Principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises. A mandaotry social metric and an ambiguous sustainability metric in our view. We suspect few financial entities or portfolio companies are aware of the requirements of the UN Global Compact Principles.

In 2019 Moody’s estimated that implementation of SFDR would increase the sectors operating costs by around 2%. We would view this as most likely to be on the low side given historic experience. Estimates of costs of new regulation tend to be incorrect often by an order of magnitude. Multiplied by the average ratio of underestimation of costs of translates to a potential increase of 12%.

We believe this estimate is not unreasonable, particularly given that many in the industry haven demonstrated an almost revolutionary zeal in the incorporation of ESG practices, when one considers the scale and granularity of required data collection for portfolio entities and compare to the scale of costs of similarly bureaucratic exercises such as AML.

We estimate the cumulative cost to the net zero target date of 2050 by assuming a continuation of PwC’s reported 5% per annum historic rate of increase of the value of EU investment assets of the last 15 years.

"An a priori assumption that harmonisation creates efficiency together with a regulatory mandate for harmonisation has been the rationale driving the development of the SFDR. "



Costing the EU's sustainable finance regulations

We estimate that the EU's sustainable finance regulations will lead to an industry wide loss of capital of between half and two and a half trillion Euros by 2050. Two and a half trillion that would be more usefully employed helping to meet the IPCC net zero target.

"we derive an annual incremental operating cost of between €36bn and €48bn for implementation of sustainable finance regulations across the EU27

We utilise two separate models for the translation of the estimates into aggregate costs.

The first approach is to treat the cost as a positive variance to a management fee applied to the value of EU investment assets. Presently €30trn.

The second was treat the cost as a positive variance to the estimated aggregate operating costs across the whole of the EU's finance sector, as had been done throughout the report of the 2019 study on the costs of compliance of the EU's finance sector by CEPS.

From these estimates we derive an annual incremental operating cost of between €36bn and €48bn for implementation of sustainable finance regulations across the EU27 Member States. A sum of similar size and scale to the estimates of current AML costs in the UK.

We believe an important policy consideration is of the scale of capital lost to the incremental compliance costs of the regulatory approach. We estimate that the EU's sustainable finance regulations will lead to an industry wide loss of capital of between half and two and a half trillion Euros by 2050. Two and a half trillion that would be more usefully employed helping to meet the IPCC net zero target.

The investing environment is unrecognisable from when the EU's sustainable finance action plan was envisaged. These were developed and conceived in an investment environment unrecognisable today. In 2022, there is double digit inflation, War in Europe and a global economy still recovering from a two-year global pandemic. It seems to us unwise to be implementing a new layer of regulatory burden of such significant cost at this juncture.

Honing the requirements down to those required under TCFD would be a more sensible and cost-effective approach. One which would better serve the IPCC climate change goals. This is the UK's route.

Conclusion

The approaches of the UK and EU to sustainable finance regulation are diverging both in matters of principle and matters of practice.

"We believe that expensive requirements for ESG type reporting of variables of ambiguous value risks undermining the cause of finance and in our view the UK is taking the better course with its focus on incorporating TCFD requirements. "

The UK regime aligns with the global TCFD standard and remains focussed on climate risk where there is clear regulatory mandate on the grounds of prudential and financial stability risk.

There is a clear golden thread from financial policy objective though to the measures imposed. The approach is simplified, principles based and in terms of reporting, metrics are transposed directly from the TCFD and applied consistently across all sectors.

The objective of the EU regime is to apply common harmonised rules across its 27 Member States. It does not particular align with the structure, recommended reporting or disclosures of the TCFD. Firms will still have the requirement, moral or regulatory, to conform to the global TCFD reporting standard and it is our premise that within Europe or those seeking to market directly into its single market will ultimately apply two levels of sustainable finance regulations to their operations: global TCFD standards and the additional requirements of SFDR.

In any event, given the scale of probable greenwashing as implied by the sudden conversation of a third of investable assets to ESG, we question the benefits of wider ESG reporting. We believe that mandatory TCFD reporting can thus serve as a reasonable proxy for general sustainability issues. With much less complexity.

We believe that expensive requirements for ESG type reporting of variables of ambiguous value risks undermining the cause of finance and in our view the UK is taking the better course with its focus on incorporating TCFD requirements.

Epilogue: Policy Implications for the Channel Islands

Finally, a comment on potential read outs for policy in the Channel Islands. Trade links are strongest with the UK and despite meeting every regulatory requirement made by the European Union, the importance of EU business is waning. For some larger firms the need to be able to market directly into Europe will require an adherence to EU SFDR requirements, but with the changing investment landscape post Brexit we believe this will be less important over time. However, the need to be aligned with the UK and global requirements will cement the importance of TCFD reporting for Guernsey and Jersey entities and funds. The GFSC has already indicated an expectation that Boards should consider climate risks in their strategic deliberations. It is only a matter of time before the reporting becomes mandatory, if only to maintain consistency with the UK. We expect the JFSC to follow a similar path.

developing sustainable research and thought

INTERNATIONAL SUSTAINABILITY INSTITUTE
CHANNEL ISLANDS

Research programme

The policy of the ISICI is to set out a proposed research programme and invite support from individuals and firms sharing our philosophy and thoughts. This can be found on our website. The research programme of the ISICI relies on patronage and sponsorship. Commissions are accepted.

Research briefings outlines the backdrop in thinking to our present proposed programme in sustainable finance. The basic premise being that the new ideas and new methods are needed to faciliate private capital of the scale required and accelerate cross border flows.

Support for the programme or individual papers is welcomed. Abstracts are available on request.

In the first instance email **contact@isici.org.**

About the ISICI

Founded by Dr Andy Sloan, the International Sustainability Institute Channel Islands was established to further the development of sustainable research and thought, advocating global fiscal, environmental and financial sustainability.

The Institute provides a forum for the exchange and development of new ideas between stakeholders across the Channel Islands.

The work of the Institute is concentrated in three key areas: global fiscal, environmental, and financial sustainability. Areas where the Channel Islands have intellectual capital, natural resource, and professional expertise that be harnessed in the pursuit of global good. Through the development of a core research programme, the Institute contributes to global thinking on strategy and policy in these chosen policy areas.

It publishes a forward-looking schedule of planned research topics. Its research programme is open to proposals, contributions, and commissions.

The Institute also provides advocacy and advisory services. Through a network of experts and researchers and leveraging the expertise of its founder, it can draw on experience of international policy work at the highest levels in fiscal, economics, finance services regulation and green and sustainable finance accrued over three decades.

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