PART I

Introduction

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The Research Handbook on EU Sustainable Finance

Regulation, Supervision and Governance

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1.1 INTRODUCTION

Sustainable finance began to occupy a prominent place in the European Union's policy agenda following the signing of the Paris Treaty on climate change in 2016 and the adoption of the United Nation's Sustainable Development Goals (SDGs).[1] The EU policy agenda was given significant support by the creation of the High-Level Task Force on Sustainable Finance in 2016, the EU Action Plan on Sustainable Finance and the Technical Expert Group on Sustainable Finance in 2018. The European Commission followed these initiatives by adopting the EU Green Deal in 2019 consisting of an ambitious package of legislative measures to assist EU citizens and businesses in benefitting from the transition to a sustainable green economy with particular focus on companies and the financial sector. The recognition of the urgency of financing the transition to a low-carbon economy and the need for mitigation of and adaptation to environmental sustainability risks are at the heart of the EU's sustainable finance strategy, which aims to mobilise and channel capital towards green and sustainable activities, products and projects.

Likewise, the EU's policy agenda and regulatory framework reflect the need to finance the green transition and limit the potential for risks and threats that could undermine economic and financial stability through a prudential approach to climate and environmental risk management, where financial institutions are expected to commit to building a resilient and sustainable financial system.

The COVID-19 pandemic also contributed to a major push for the EU's sustainable finance agenda, as it fostered the EU's green financial capacities through the NextGeneration EU (NGEU) instrument, where around 30% of the NGEU's Recovery and Resilience Fund (RRF) will be financed through green bonds.[2] The

[1] See THE 17 GOALS | Sustainable Development (https://sdgs.un.org/goals). In January 2015, the UN General Assembly began the negotiations on the post-2015 development agenda that culminated in the subsequent adoption of the 2030 Agenda for Sustainable Development, which included the 17 Sustainable Development Goals, at the UN Sustainable Development Summit in September 2015.

[2] European Commission, 'NextGenerationEU Green Bonds', available at: https://bit.ly/3V6APxo.

EU has also recognised the urgency for financial institutions to integrate ESG factors into their business models and risk management strategies, with the aim of ensuring that the entire financial sector plays a key role in driving the transition to a sustainable economy, and also intends to continue exploring new ways to increase the mobilisation of private capital towards sustainable investments.[3] On the latter, a number of important new policy initiatives have been emerging, but much remains to be done to address ESG-related challenges.

As policy developments are moving quickly, they represent a major challenge for financial institutions and their regulators and supervisors to adapt to these policy changes while at the same time striving to contribute to a resilient and sustainable economy and financial system. Recent EU legislation to address climate change and broader ESG challenges have precipitated a major debate across the Atlantic and globally regarding whether financial regulation and corporate governance should integrate climate and ESG concerns into day-to-day risk management and business practices. EU legislation, such as the Taxonomy Regulation, the EU Green Bond Standard, the Sustainable Finance Disclosure Regulation (SFDR), the Corporate Sustainability Reporting Directive (CSRD), the amendments to the Benchmark Regulation (extending its application to Climate Benchmarks) and the recently approved Regulation on ESG Rating Providers are influencing legislative and regulatory developments in many countries outside the EU. Not only can this legislation serve as a model for future reforms worldwide, but the EU regimes for the recognition of equivalence (or, in some cases, for the endorsement) of activities based outside the Union will inevitably have an impact on third-country service providers wishing to enter EU financial markets.

Moreover, the multiple manifestations of the environmental and climate crisis have brought a previously unknown spectrum of financial risks to the fore. Weather events and chronic shifts in temperature, as well as changes in policies and consumer preferences brought about by the transition to a low-carbon economy, are only a few examples of potential drivers of financial risks that can spill over into the banking and financial sector and the broader economy. Indeed, financially material environmental sustainability risks are posing major challenges for financial regulatory authorities.

As market actors have increasingly acknowledged the relevance of these risks, financial regulators and supervisors in countries outside of Europe have also started to take action to address them in their daily operations and supervisory activities. Transnational *fora* like the Network for Greening the Financial System (NGFS) have played a pivotal role in facilitating the exchange of best practices among central banks and other bank regulators in the design of crucial tools for the management and supervision of financially material physical and transition risks, such as the design of climate stress tests and scenario analysis. The Climate Financial Disclosure

[3] For this task, the EU Commission has launched the International Platform on Sustainable Finance.

Standards (TCFD) led by the Financial Stability Board have provided a benchmark for disclosure approaches that some major corporates have taken up on a voluntary basis, while the International Organisation of Securities Commissions (IOSCO) has made progress in further developing disclosure standards for listed companies that are more standardised and comparable. And the International Sustainability Standards Board (ISSB) has begun work on how to incorporate sustainability risks into accounting valuation methodologies. The G20/OECD Principles of Corporate Governance, in their 2023 edition, address companies' sustainability and long-term resilience by focusing on environmental and social risk management.

It is of utmost importance therefore for regulators and supervisory authorities to understand as well as to engage in a constructive dialogue on environmental and social-related financial risks with corporate boards and senior management. Sharing and learning from best practices are essential steps which could contribute to the global sustainable finance agenda. Against this backdrop, ESG challenges, including climate-related financial risks, have profoundly transformed, and may transform in the not-so-distant future, business strategies, governance practices and risk management.

In light of these developments, this book was undertaken as part of the research project supported by the Jean Monnet Centre on European Union Sustainable Finance and Law (EUSFiL) at the University Genoa and the Research Network for Sustainable Finance. The EUSFiL Jean Monnet Centre and the Research Network assembled a group of academics and practitioners whose research focusses on the legal implications of the integration of sustainability in the corporate and financial sector. The group of contributors to this volume comes from across disciplines, including law, economics and finance, management and accounting. They have approached their topics from the perspective of how ESG challenges are transforming how we understand the law and regulation of corporate governance and banking and financial market activities. Indeed, the work of the authors contributes to the book's overall theme of developing a better understanding of how ESG challenges are transforming financial regulation and supervision and the governance of institutions and firms from a European and comparative perspective.

Although the main focus is on developments in the European Union, the book also provides a comparative analysis between the EU and other countries outside Europe, such as the United States. The chapters aim to provide the reader with relevant knowledge and analytical tools to better understand and critically reflect on the potential opportunities and challenges posed by the new legislative and regulatory developments in the area of ESG and sustainable finance. The book's content and analytical focus is relevant for academics, policymakers, financial regulators and supervisors, and private finance and corporate governance practitioners.

The book is divided into 5 parts and 29 chapters. Part I consists of the chapter entitled 'Taking Financing Seriously: Understanding the Financial Risks of Unsustainability', which addresses various areas of corporate law and governance in the context of ESG management and stakeholder theory. In this chapter, Beate Sjåfjell investigates the relationship between finance and sustainability through a broad analysis of the risks of unsustainability beyond the established scope of financial risks related to climate change. She analyses the problems of the mainstream approach to finance, sustainability and risks, and reviews the ongoing development of a framework to manage the financial risks of biodiversity loss. She discusses the research-based concept of sustainability and how the concept of planetary boundaries has significance in finance on three interconnected levels: first, it reminds us of the ecological limits; second, it highlights the complex interaction between planet-level environmental processes and that climate change is only one aspect of the convergence of crises; third, it emphasises the importance of using the state-of-the-art natural science in making decisions on a work-in-progress basis. She also explores a systemic approach to Anthropocene risks and analyses the financial risks of unsustainability in the categories of transition, physical and societal risks. She concludes with brief reflections on the necessity of implementing a research-based approach to risks of unsustainability in law, policy reforms and practice as well as the legal basis in the European Union for achieving these tasks.

Part II, entitled ‘Ethics and Sustainability in Corporate Law, Corporate Governance and Conduct’, consists of seven chapters, which examine how the new concerns on sustainability and business ethics meet traditional theories on corporate governance and corporate conduct. In Chapter 3, ‘Firm Value versus Social Value: Dealing with the Trade-Offs’, Guido Ferrarini examines the main trade-offs between the economic value and social value of the firm and discusses how they are solved through corporate governance mechanisms under ethical and regulatory constraints. In doing so, he analyses how enlightened shareholder value (ESV) under the influence of stakeholder theory involves trade-offs between firm value and social value. He argues that the purpose of the corporation should be redefined in terms of shared value, not just in terms of shareholder profit maximisation. He then discusses the recent criticism of ESV from the perspectives of radical shareholder value and social value primacy. He suggests that ESV is conveniently complemented by business ethics, soft law and regulation. He further explores recent scholarship on corporate governance and organisational theory and analyses the theory of corporate purpose and the organisational perspective on corporate purpose in connection with sustainability. He further develops his argument to show how business ethics, soft law and regulation constrain the maximisation of firm value by forcing enterprises to internalise some of the externalities produced in their activities. Finally, he concludes that enlightened shareholder value explains how the pursuit of stakeholder value contributes to firm value maximisation and the creation of social value. The board of directors should identify the ethical and cultural values of the firm and monitor their application at all levels. In this regard, organisational purpose should play a fundamental role in the intrinsic motivation of people in corporations.

In Chapter 4, 'The Hardening of Corporate ESG', Genevieve Helleringer and Christina Parajon Skinner discuss how major businesses worldwide have declared their commitment to the stakeholder model, and how a growing number of firms have carried their stakeholder commitments forward in the form of environmental, social and governance (ESG) initiatives. This chapter questions whether the current trend of ESG that stakeholderism is a sustainable business practice over a longer time horizon and discusses how voluntary corporate ESG commitments have hardened into more formal sources of law and regulation in the US, EU and the UK. It first explores the domestic legislative initiatives in France and Germany and their potential to inspire EU ambitions before exploring the legislative initiatives in the EU and the UK, respectively. It then explores the legislative and regulatory changes in the USA at the federal and state level and how court rulings have recognised ESG norms as instruments of transforming soft ESG commitments into hard common law precedents. Finally, it argues that the hardening of the ESG commitments into formal law may risk fossilising unworkable standards for firms and forcing misallocations of capital over time as the new ESG-related rules and regulations are bound to bump up against the existing fiduciary duties of firm managers and board directors. Moreover, the EU rules on the value chain will become binding rules extraterritorially as the European value chain requirements may leave little margin of negotiation for US suppliers.

Monika Marcinkowska addresses stakeholder engagement in Chapter 5, 'Stakeholder Engagement'. She contends that stakeholder engagement is a cornerstone for the implementation of the Sustainable Development Goals (SDGs). The SDGs framework can be defined as a pragmatic stakeholder engagement model and financial institutions play a key role in achieving the SDGs through their indirect influence on a wide range of stakeholders, including customers and partners. Stakeholder engagement is essential in the implementation of a sustainable financial strategy and the management of stakeholder engagement is crucial in terms of assessing the sustainability of the financial institution. With this backdrop, she reviews stakeholder theory by analysing the concepts of stakeholders in the context of contract theory and corporate social responsibility, and of financial firms' responsibility in the four categories of economic, legal, ethical and discretionary responsibility. Finally, she reviews the concept of relational capital, which represents the totality of the firm's relationships and links with its stakeholders based on mutual trust. She then discusses the four stages of stakeholder engagement management, including the identification of stakeholders, stakeholder analysis, stakeholder prioritisation and selection of engagement strategies, and monitoring and evaluation of stakeholder relations. She concludes that creating value for shareholders requires meeting the specific expectations of different stakeholder groups and that conscious stakeholder relationship management is required to effectively create this value. Fundamentally, stakeholder relationship management is an ongoing process and successive iterations should be carried out periodically. A company's stakeholder engagement strategies may need to be adapted as the company's environment and stakeholder expectations evolve over time.

In Chapter 6, 'Bank Governance and Sustainability', Kern Alexander discusses the importance of decision-making and agency problems in bank governance with particular focus on the role of the board of directors in addressing sustainability risks that are increasingly affecting the banking business. He discusses the centrality of the banking business and the role it can play in leading the economy in the transition to net-zero carbon emissions and other sustainability objectives. The chapter then considers traditional agency theories that underpin corporate governance and suggests that they do not offer a full explanation of the 'collective' agency problems that exist in large, complex organisations, such as banks and other financial institutions. Human agency theory offers an alternative theory that emphasises the importance of organisational culture in determining standards, norms and values that influence agent behaviour. The importance of the board is considered in ensuring an adequate risk culture to address organisational failings and in confronting new business challenges, such as climate financial risks. Although the role of bank boards and senior management is primary, regulatory intervention may be necessary to ensure that organisational practices are adequately managing agency problems regarding sustainability concerns. The UK Senior Manager's Regime is considered an intrusive approach involving regulators holding bank boards and senior management personally accountable for regulatory failings as well as designing and complying with the organisation's sustainability strategy. The chapter concludes with some recommendations for how bank governance and business practices could be improved to support society's sustainability objectives.

In Chapter 7, titled 'Risk Culture and Sustainability', Paola Schwizer, Simona Cosma and Lorenzo Nobile address the challenge of regulating risk culture in companies in order to achieve sustainability outcomes. The authors note that a risk-based cultural approach that embeds sustainability values could support the adoption of pro-environmental strategies (PES) by corporations. The chapter investigates the relationship between risk culture and drivers of environmentally sustainable behaviours that could encourage the adoption of PES by board members. It analyses a survey of 120 Italian board members to test the relationship between individual risk culture and beliefs, attitudes and norms. The authors then explore the literature on corporate culture, sustainability culture and risk culture. Corporate culture is a driving factor of sustainability performance, and the failure in cultural change can be an obstacle to sustainable development. Sustainability culture implies the importance of environmental and social objectives in addition to financial performance and has qualifying characteristics such as long-term orientation and the maximisation of stakeholder value. Risk culture refers to the corporate culture that focusses on risk-taking and risk-control activities. The goal of risk management is not only the elimination of risk but also the search for an optimal balance between risk assumption and risk prevention and mitigation. The chapter then analyses the governance of emerging risks as a key driver for sustainability using Ajzen's theory of planned behaviour (ATPB). It tries to establish whether a stronger risk culture is positively related to more favourable assumptions and implicit values, which refer to beliefs about the types of goals firm members should pursue as well as ideas regarding standards of behaviour. The authors conclude that a positive relationship between directors' level of risk culture and behavioural, normative and control beliefs exists. Thus risk culture must be shaped to incorporate sustainability-related values throughout the organisation and the management style must be adapted to the risk culture to enhance the ability to explore new market opportunities.

In Chapter 8, 'Conduct Risk as a Possible Approach for Enhancing Awareness and Management of ESG-related Risks', Antonella Sciarrone Alibrandi, Claudio Frigeni and Giulia Schneider address how severe misconduct patterns in financial firms impact market integrity and financial stability. To this end, the chapter explores the sources and features of conduct risk, which they consider a direct result of poor firm culture and the outcome of short term–oriented business models. The misconduct problems in financial firms are related to both retail conduct risk and wholesale conduct risk, and European supervisory authorities have made policy statements and guidelines on managing conduct risk. However, uncertainties persist regarding what conduct risk exactly is, and what types of risk it encompasses. In this regard, the chapter highlights that conduct risk is sometimes understood in a flexible manner, encompassing all the sources of misconduct that can lead to poor outcomes for the customers, particularly in conjunction with the violation of extra-legal parameters. In other contexts, instead, conduct risk is meant to be a subset of operational risk. Against this backdrop, this chapter discusses the role of conduct risk in the evolving ESG-related regulation initiatives and argues that the flexible and cultural-sensitive nature of conduct risk makes it an effective tool for the forecast, correction and prevention of potentially harmful misconduct directly stemming from the missed or wrongful enactment of ESG policies. Therefore, while conduct risk does not coincide with ESG risk, it may be a tool to reconsider internal risk management systems with a view to reduce the risk of inappropriate behaviour that may lead to unsustainability, thus also strengthening bank stability in a prudential perspective.

In Chapter 9, entitled 'Sustainability and Executive Compensation', Roberto Barontini and Jennifer Hill observe that executive pay has undergone several major interpretations in recent decades, while a more complex picture of the corporation has emerged as the source of negative externalities from misconduct, corporate scandals and financial crises. The chapter provides an overview of developments relating to the design and regulation of executive pay over the last few decades, including the rise of integration of sustainability and ESG targets into executive compensation packages. It also examines the reasons for this development through empirical analyses focussing on the prevalence of this trend in publicly listed companies. This involves a short history of executive compensation in three aspects: a corporate theory of executive compensation design, post-scandal regulatory responses to executive compensation from Enron to the Global Financial Crisis, and executive compensation in the ESG era. The authors then provide an empirical analysis of the prevalence of 'pay for sustainable performance' in contemporary executive compensation contracts. In doing so, the chapter examines the macro-determinants of ESG compensation and the financial and corporate governance variables that influence the ESG performance and communication of the firm. The authors conclude that the increasing integration of ESG targets in executive compensation as a result of pressure from both regulators and institutional investors could be ineffective, given the risk of agency problems and greenwashing. Therefore, it is unclear whether the trend of integrating ESG into executive compensation will continue and whether it will translate into more sustainable corporate practices in the future.

Part III, entitled 'Integrating Sustainability in Financial Markets Regulation', consists of eight chapters addressing the evolving relationship between capital markets and their traditional institutions on the one hand, and the new trends in sustainability and ESG-related preferences on the other. In Chapter 10, 'Sustainability-related Materiality in the SFDR', Nathan de Arriba-Sellier and Arnaud Van Caenegem analyse the EU Sustainable Finance Disclosure Regulation (SFDR) by proposing that we should think about the SFDR as a layered system of sustainability-related disclosures, which combine the concepts of 'single materiality' and 'double materiality'. The authors offer a new perspective on popular proposals to turn the SFDR into a labelling scheme but argue that supervisors should avoid such avenues. The chapter explains the difficulties that arise from the vaguely defined principle of 'sustainable investment' under the SFDR. The SFDR provides a framework within which financial market participants can define their own objectives and contributions. Therefore, the chapter emphasises that it is not the definition of 'sustainable investment' which is relevant, but the additional disclosure requirements that apply as soon as a financial market participant deems its financial product to be in line with the definition. The SFDR encourages robust internal assessments over blind reliance on opaque ESG rating agencies and provides financial market participants with the freedom to justify what a contribution to an environmental or social objective means. This freedom sets it apart from a labelling mechanism with a clearly defined threshold of what a contribution should entail. The chapter also analyses proposed guidelines by ESMA for regulating the names of investment funds that involve sustainable investment, and concludes that those guidelines do not create a clear labelling regime since they primarily focus on disclosure rather than providing a specific framework for classifying financial products.

In Chapter 11, 'Information Intermediaries and Sustainability: The Case of ESG Ratings and Benchmarks', Matteo Gargantini and Michele Siri analyse the important role of information intermediaries, such as ESG ratings agencies and administrators of sustainability benchmarks. The chapter compares the rationale for regulating traditional providers of ratings and benchmarks with the market failures characterising those services when they focus on sustainability. The results of the comparison vary, in part, depending on the role ESG factors play. For instance, while credit ratings often include ESG factors in their assessment with a view to determining reputational and other risks (outside-in perspective), sustainability ratings that focus on impact alone (inside-out perspective) may have a different nature. In a double materiality perspective, issues of asymmetric information and agency problems may therefore be more pervasive for sustainable ratings and benchmarks compared to their traditional peers. However, those services may also be more prone to regulatory failures, if only because knowledge problems seem to affect regulators and supervisors just like investors and other users of ratings and benchmarks. In the authors' view, the EU Regulation on Benchmarks, which already provides a general framework and specific rules for sustainability benchmarks, strikes a good balance in that it addresses the most critical features of indices while calibrating its provisions in light of the benchmark's features. On the contrary, the current lack of rules concerning ESG ratings warrants adequate policy measures. While this gap will soon be filled by an EU Regulation, the authors express some doubts on the regulatory strategy behind it.

Veerle Colaert assesses in Chapter 12, 'On the Sustainability of the MiFID II and IDD Investor Protection Frameworks', the extent of integration of sustainable finance into the market in Financial Instruments Directive II (MiFID II) and the Insurance Distribution Directive (IDD) investor protection frameworks. Sustainable finance has become a new EU priority and a substantial number of measures proposed in the Eighth Climate Action Plan that the European Commission adopted in March 2018 have led to important changes to the MiFID II and IDD investor protection frameworks. As background, she explains why retail investors do not always act upon their investment preferences and the role of the investment product distributor in remedying investors' value-action gap. She discusses the main changes to the MiFID II and IDD investor protection frameworks and the challenges of the revised legal framework by analysing the new sustainability-related definitions, the amended product suitability assessment, the amended product governance process and the amended conflicts of interest procedure. She argues that full cross-sectional consistency will not be achieved in the EU investor protection framework as only the MiFID II and IDD frameworks have been amended while rules covering other product distributors remain the same. She critically evaluates the revised investor protection rules for the suitability test, product governance and conflict of interests. She also addresses the problems of inconsistency caused by sustainable finance amendments to existing legislation. Finally, she discusses the problems of applying the definition of sustainability preferences, which refer to concepts of the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation, and the lack of complete a Taxonomy covering social and governance perspectives in the amended MiFID II and IDD obligations.

In Chapter 13, on 'The EU Taxonomy Regulation and the Prevention of Greenwashing', Marleen Och examines how the EU Taxonomy Regulation provides definitions to determine whether an economic activity is environmentally