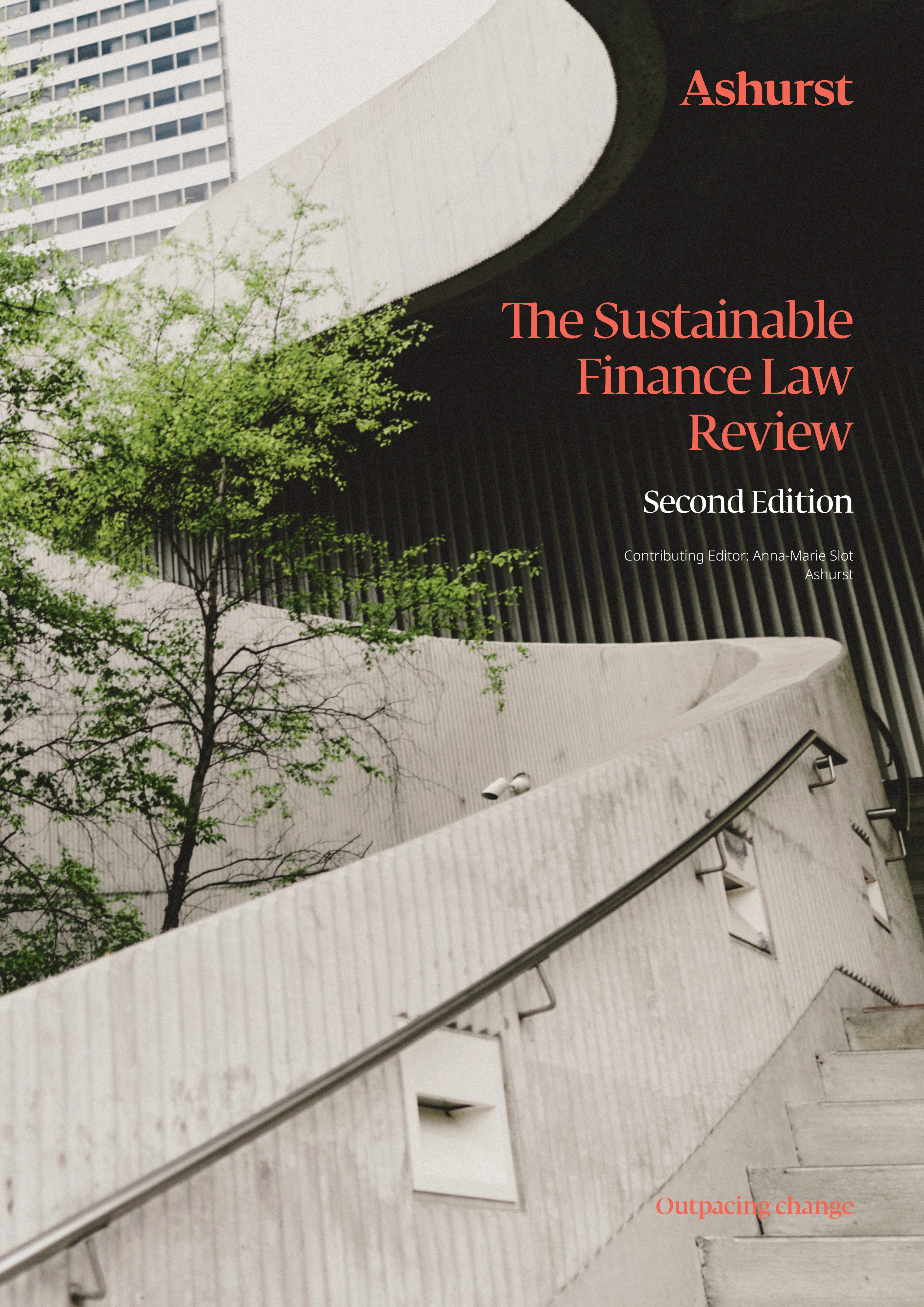

Ashurst

The Sustainable Finance Law Review

Second Edition

Contributing Editor: Anna-Marie Slot
Ashurst

Outpacing change

Sustainable Finance Law

EDITION 2

Contributing Editor

Anna-Marie Slot

Ashurst

In-Depth: Sustainable Finance Law (formerly The Sustainable Finance Law Review) provides a practical global overview of the current state of sustainable finance and related regulatory efforts across multiple jurisdictions. It also tracks the evolution of sustainable finance and outlines key trends for the near future. Topics examined include sustainable disclosure requirements and taxonomies, sustainable finance instruments and incentives, and much more.

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Editor's Preface

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Sustainable finance is rapidly evolving. Public and private financing of sustainable and green projects, or those with provisions in line with borrowers' and issuers' environmental, social and governance (ESG) commitments, has increased significantly. Since the signing of the Paris Agreement in 2015, more than 190 countries have committed to net zero emissions targets. Countries have also acted at a national level with ambitious target-setting and nationally determined contributions (NDCs) pursuant to the Paris Agreement. They are not alone. The share of large publicly-listed companies with net zero targets has more than doubled in a little over two years, from 417 to 929 (Net Zero Tracker Stocktake 2023 – see https://zerotracker.net/analysis/net-zero-stocktake-2023). Financial institutions have also engaged with various policies introduced to enshrine ESG commitments, in terms of both their own lending targets and the carbon emissions linked to those targets. Investors at both retail and institutional levels increasingly look to the financial markets as an important lever in achieving such targets. With new regulations and the evolving investor appetite, the sustainable investing landscape continues to shift.

In 2023, the volume of green, social, sustainability, sustainability-linked and transition finance (collectively known as GSS+ finance) continued to grow, reaching a combined total of US$4.2 trillion. The US share of the GSSS+ volume fell in 2022, probably as a response to the anti-ESG political developments. This follows a slowdown in 2022 in GSS+ finance as banks, investment funds and asset managers kept billions of dollars away from sustainable investments. In Europe, the impact of the Sustainable Finance Disclosure Regulation (SFDR) was scrutinised by regulators. SFDR requires financial products, predominantly funds, to make certain disclosures depending on their 'categorisation': dark green, light green or neutral. Around US$140 billion of investments previously considered 'dark green' was downgraded as a result. Underscoring the gap between the actual level of green finance and what is needed to support the transition to a decarbonised global economy. the Climate Bonds Initiative, which is an international not-for-profit organisation working to mobilise global capital for climate action, noted that 'though sustainable finance is on its way to being a $5 trillion market, we need to see $5 trillion of sustainable finance being raised annually in the latter half of the decade, to prevent future climate collapse' (Climate Bonds Initiative, Green and labelled finance markets hit $4Trillion mark, 11 August 2023: (https://www.climatebonds.net/2023/08/green-and-labelled-finance-markets-hit-4trillion-mark)).

For over three decades, the United Nations has brought together almost every country on earth for the global climate summits – known as the Conference of the Parties (COP).Significant progress has been made in the international community with respect to global sustainability reporting standards since COP27. The current focus for companies and regulators alike is to iron out some of the challenges and to ensure that the data is being used to actually reorientate the capital flows towards sustainable investments. Precisely what some of those challenges are is a live debate, and the discussions regarding the purpose of sustainable finance cover a wide spectrum of issues – from greenwashing to the fundamental shift of credit, including the risks and opportunities of ESG considerations. The emphasis should be on action to not only find solutions to decarbonise the economy, but also to strengthen the broader ESG aims including the recovery of nature.

Notwithstanding ongoing considerations about the purpose of sustainable finance, financial market participants have reacted by creating a wide variety of financial products marketed as sustainable, green or ESG-friendly. The rapid increase in both supply of and demand for sustainable investment products has, at times, resulted in a lack of consistency, transparency and reliability of disclosures and metrics. Governments and regulatory bodies are increasingly focused on imposing guidelines and frameworks to address these issues. Although sustainable finance continues to elude strict definition at present, significant efforts are being made globally to ensure quality and transparency in the industry, to impose consistent frameworks such as the International Sustainability Standards Board (ISSB) and disclosure requirements such as those of the Task Force on Climate-related Financial Disclosures (TCFD) that support comparability and interoperability among firms and products, and to provide investors with sufficient information to monitor the impact of their investments.

In this second edition we aim to:

1. provide a snapshot of the current state of sustainable finance and the status of regulatory efforts across multiple jurisdictions; and
2. track the evolution of sustainable finance and outline key trends for the near future.

I thank all of the contributors for their expertise, hard work and dedication in producing this volume.

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Introduction

Increasing consideration for environmental, social and governance (ESG) aspects in investment decisions has become a global demand among investors, public authorities and companies. To attend to such requirements, companies, and the market in general, aim at fostering sustainable practices, increasingly solid governance and structuring transactions related to those sustainable standards.

The scenario is no different in Brazil: even though its sustainable finance framework is still at an early stage in the development of specific rules on ESG factors, it is remarkable how the legislation on the matter is in constant development and the Brazilian legal framework is provided with general rules that allow companies, managers and the securities market to analyse these factors in their investment decisions.

Companies are embracing sustainable local and external debt financing with enthusiasm and adjusting themselves to recently enacted legislation, regulation and self-regulation to align their corporate governance and disclosures with international standards. As part of this recent regulatory trend, the Brazilian Securities and Exchange Commission (CVM) has modernised rules applicable to publicly held companies, setting forth parameters for ESG information to be disclosed by listed companies.

Year in review

During the past year, there have been new developments of the Brazilian legal framework towards the ESG triad, such as the Sustainable Finance Action Plan for 2023–2024 published on 6 October 2023 as a response of the Sustainable Financial Policy issued by the CVM on 30 January 2023, as well as the refinement of the regulation regarding Agribusiness Production Chain Investment Funds (Fiagro). Nevertheless, there still is considerable work to be done (e.g., the majority of the bills presented to the National Congress in 2022, or earlier, are pending approval).

Regulation and policy

i Governance regime

Governance of sustainable financing in Brazil involves a complex web of laws, regulations, policies, and best practices aimed at promoting ESG considerations in financial activities, even though the Brazilian legal and regulatory framework regarding sustainable finance is still in its early stages.

The Brazilian Constitution recognises a balanced environment as a fundamental right and provides the duty of the Brazilian government to protect it. Under this, the Brazilian Congress had enacted through the years fundamental laws aiming at the protection of the environment, such as: (1) the Brazilian Forest Code; (2) the National Environmental Policy; and (3) the National Policy on Climate Change.

As to sustainable finance, there are certain general rules, such as Law 13,986, of 7 April 2020 (the Agro Law), which is an important tool to reduce unnecessary bureaucracy and promote economic development without losing sight of the environmental sustainability that is required under sustainable standards.

In the current scenario, the development of companies that do not incorporate such standards is no longer assumed. Federal and state governments have seen attractive ways to promote environmental conservation and, as a consequence, encourage companies to adapt themselves to environmental standards and to reposition themselves in the ESG market by using the environmental sphere as an example, sensitive to the current perspective and, in an intelligent way, combining the opportunity to make new business viable in the national and international spheres with the common objective of regularisation and environmental preservation. These public policies bring clear, general, broad and common benefits to the private sector, public authorities and civil society.

Governance of sustainable financing in Brazil is a dynamic and evolving field. It involves a combination of legal frameworks, regulatory bodies, industry initiatives and best practices to encourage responsible and sustainable financial practices.

There is also the engagement of Brazil with sustainable development and climate action, including its commitments and initiatives related to the UN 2030 Agenda, sustainable development goals (SDGs), its nationally determined contributions (NDCs) under the Paris Agreement, the 2030 climate target plan, net zero commitments and risk frameworks.

Brazil is a signatory to the 2030 Agenda for Sustainable Development and has made efforts to align its national policies with the SDGs. The country has taken steps to integrate the SDGs into its national development plans and strategies, which includes tackling poverty and inequality, addressing environmental issues, promoting sustainable agriculture and ensuring access to education and healthcare.

As to the NDCs under the Paris Agreement, Brazil submitted its NDC, which encompass a commitment to reduce greenhouse gas emissions by 37 per cent below 2005 levels by 2025 and a goal to achieve a 43 per cent reduction by 2030. Brazil aimed to reach these targets primarily through reducing deforestation and expanding reforestation efforts. A significant portion of Brazil's NDC focuses on curbing deforestation and improving sustainable land use practices in the Amazon and other critical ecosystems.

Under the 2030 Climate Target Plan, Brazil has: (1) established the Amazon Fund, which is aimed at promoting sustainable development and conservation of the Amazon rainforest, playing a crucial role in achieving the climate targets by reducing deforestation; and (2) made investments in renewable energy sources, particularly hydropower and biofuels. The country has one of the world's largest shares of renewable energy in its energy matrix.

Currently, Brazil does not have a legally binding net zero commitment. However, there have been discussions and proposals in this regard. Pressure from the international community, investors and domestic stakeholders has led to increased discussions about the need for a net zero commitment in Brazil.

The governance regime for sustainable financing in Brazil has some noteworthy aspects that distinguish it in high-level terms. Brazil is home to a vast and diverse range of ecosystems and natural resources, including the Amazon rainforest. The country's approach to sustainable financing reflects its unique environmental challenges and opportunities, making it distinct in terms of the scale and significance of its natural assets.

The sustainable financing regime in Brazil places a strong emphasis on addressing deforestation and sustainable land use. Given the prominence of agriculture and forestry in the Brazilian economy, these issues have a significant impact on the country's environmental and economic sustainability.

The establishment of the Amazon Fund, which encourages investment in projects focused on the conservation of the Amazon rainforest, is a noteworthy initiative. It exemplifies Brazil's commitment to leveraging sustainable financing mechanisms for environmental preservation.

In summary, Brazil's governance of sustainable financing is distinct due to its significant environmental assets, its focus on addressing deforestation and land use, its role in global climate mitigation, the presence of initiatives like the Amazon Fund and the country's evolving regulatory framework. The country's approach is shaped by its unique environmental and social challenges and is characterised by stakeholder engagement and the growing incorporation of ESG principles in financial decision-making.

On 19 May 2022, Decree No. 11,075 established the procedures for the preparation of sectoral climate change mitigation plans and instituted the national system for the reduction of greenhouse gas emissions. Inspired by the Paris Agreement, this is undeniably a move toward legislative improvements. Decree No. 11,075 also sets forth that deadlines and rules for updating sectoral climate change mitigation plans will be defined when they are prepared by the competent bodies, and the commitments assumed by the country under the United Nations Framework Convention on Climate Change will be observed through nationally determined contributions.

On 30 January 2023, the CVM launched the Sustainable Financial Policy, aiming at assisting in strengthening the attributions, consolidation, organisation and structuring of the CVM's sustainable finance work, as well as improving the dissemination and communication of activity results concerning sustainability. The main policy guideline is to promote sustainable finance within the capital market. In accordance with the Sustainable Financial Policy, the CVM has, on 6 October 2023, launched the Sustainable Finance Action Plan for 2023–2024.

The CVM has also enacted a new regulatory framework for investment funds in Brazil, issued on 23 December 2022 under CVM Resolution No. 175. This Resolution has also added carbon credits to the list of eligible assets to be purchased and traded by investment funds. For the moment, the CVM has authorised investments exclusively in carbon credits currently existing under Brazilian regulation, such as the Decarbonisation Credits, which must be registered in financial settlement and registration systems accredited with the CVM and the Brazilian Central Bank (BCB) or traded in organised markets accredited with the CVM.

Following the entry into force of CVM Resolution No. 175, the CVM initiated Public Consultation SDM 03/2023 on 31 October 2023 (the Public Consultation) to discuss a proposal for regulation on agribusiness production chain investment funds (fiagros). The Public Consultation is designed to gather input from stakeholders over the issuance of a definitive regulatory framework for fiagros. This initiative is part of the CVM's regulatory agenda released in December 2022, and underscores the importance of the agribusiness industry in Brazil, alongside a strategy to enhance its presence in the capital markets.

Additionally, the draft regulation underscores the disclosure requirements with respect to the methodology under which the fiagro, bearing names featuring words like 'carbon' or other terms and expressions associated with reducing and eliminating greenhouse gases from the atmosphere, will comply with the relevant investment policy.

Throughout the year in review, the Brazilian Financial and Capital Markets Association (ANBIMA) has expanded its ESG self-regulation to other classes of investment funds. On 16 June 2023, ANBIMA published new rules and procedures for investments in sustainable assets, which entered into force on 13 July 2023.

The amendments aim to extend the criteria for identifying funds focused on sustainable investments, or that incorporate ESG factors into other types of funds (in addition to equity and fixed income funds, which were previously covered by self-regulation), such as FIDCs, quota investment funds (FICs), multimarket funds and ETFs. The amendments target fund managers and funds that wish to incorporate ESG criteria into their investment strategies. The managers of these investment funds must have a specific and detailed internal policy for funds incorporating ESG factors, which must be approved by senior management and published on their website. In addition, they must rely on qualified professionals and establish reporting methods.

ii Regulators

Since the ESG topic is in vogue and the legal framework regarding ESG is still under development, the governmental agencies that most work with players of the capital markets have issued a few rules regarding ESG matters. Those rules are closely related to sustainable financing, since investors are more likely to be part of a structure that also concerns the environment.

In Brazil, several bodies play key roles in regulating, enforcing and promoting the sustainable finance framework. These entities collaborate to shape policies, enforce regulations and support sustainable finance initiatives.

The BCB is the country's central monetary authority, and it plays a crucial role in shaping and implementing sustainable finance policies. The BCB issues guidelines and regulations that encourage financial institutions to consider ESG factors in their risk management practices.

The CVM is responsible for regulating the securities and capital markets in Brazil and has guidelines and regulations that promote ESG disclosure by listed companies, contributing to transparency in sustainable finance.

It is important to highlight that both the BCB and the CVM are independent bodies that also have sole discretion to apply penalties or to deny requests should they understand that an applicant or a party in a procedure has not complied with their rules. Thus, even though these bodies are not responsible for ESG matters, they play an important role in improving the sector and its regulations.

The Brazilian Sustainable Finance Committee is a multi-stakeholder platform that promotes sustainable finance practices in Brazil and facilitates collaboration among government agencies, financial institutions, businesses and civil society to advance sustainable finance initiatives.

The National Monetary Council is responsible for formulating monetary and credit policies in Brazil and may contribute to the regulatory framework for sustainable finance and ESG considerations.

The National Development Bank (BNDES) is a key financial institution that supports development projects in Brazil. The BNDES may be involved in financing projects aligned with sustainable development goals and promoting environmentally responsible practices.

The Brazilian Development Bank and Caixa Econômica Federal are state-owned banks that are influential in the financial sector and may adopt sustainable finance practices and support projects with positive social and environmental impacts.

There are also non-governmental organisations (NGOs) that play a vital role in advocating for sustainable finance and promoting best practices. NGOs often contribute by engaging with stakeholders, conducting research and advocating for policies that advance sustainable finance.

Brazil engages with supranational organisations, such as the United Nations and the World Bank, in global efforts to promote sustainable development. Collaboration with these organisations may involve accessing financial support, participating in global initiatives and aligning national policies with international standards.

Brazil may have national sustainable finance roadmaps or strategies that outline the country's vision and objectives in promoting sustainability in the financial sector. Initiatives such as the Amazon Fund and potential government-backed programmes can provide financial support for projects contributing to environmental conservation and sustainable development.

Sustainable finance instruments

Sustainable finance instruments are instruments for green and sustainable transactions in the Brazilian capital markets. Additionally, there are specific financial instruments existing under Brazilian legislation, with the most used financial instruments being bonds, agribusiness receivables certificates, financial rural product certificates, certified emission reductions and quotas of ESG investment funds.

Green and sustainable transactions involve companies or vehicles that have allocated funds to finance both environmental and social governance-focused sustainable projects in the most diverse sectors, including agribusiness and infrastructure, as well as in the wholesale, retail and food sectors. Depending on the structure of each case, it is possible to set forth obligations to ensure that the funds will be effectively allocated to those green and sustainable projects.

Green bonds are debt instruments specifically earmarked to finance environmentally sustainable projects. Brazilian issuers, including both public and private entities, have increasingly shown interest in issuing green bonds to fund projects with positive environmental impacts. The funds raised through these bonds are directed towards renewable energy, sustainable agriculture and other green initiatives.

Sustainability-linked loans are loans where the terms are tied to the borrower's achievement of predetermined sustainability performance targets. Companies in Brazil, particularly those in sectors with significant environmental and social footprints, may enter sustainability-linked loans as a way to align their financing with sustainability goals. These loans incentivise borrowers to improve their ESG performance over time.

Social bonds are financial instruments designed to raise funds for projects that have a positive social impact, such as those addressing poverty, healthcare or education. Social bonds may be used by Brazilian entities to finance projects that contribute to social development and well-being.

Green and sustainable finance programmes are government-backed or institutional programmes that channel financial resources into sustainable projects and initiatives. Brazil may have specific programmes or funds, such as the Amazon Fund, that support green and sustainable finance projects. These initiatives aim to preserve the environment, address climate change and promote sustainable development.

Sustainable development loans are loans specifically directed towards projects that contribute to sustainable development goals. Financial institutions in Brazil may offer sustainable development loans to businesses and projects that demonstrate a commitment to environmental and social responsibility.

Sustainable disclosure requirements and taxonomy

Recent regulations issued in Brazil set forth requirements regarding sustainable disclosure by financial institutions and publicly held companies.

In 2021, the BCB, in accordance with the recommendations of the Taskforce on Climate related Financial Disclosures and with the Basel Committee papers on the subject, issued several new ESG practice requirements for banks that are already in force or that are to be in force by the end of 2023.

These rules provide for, among other provisions, the risk management framework, the capital management framework and the information disclosure policy. From now on, social, environmental and climate risks must be integrated into the risk management process, requiring the development of new mechanisms that allow these activities to be carried out.

The CVM has also started working on issuing ESG rules. CVM Resolution No. 59 establishes that companies registered before the CVM will have one year to adapt to the new rules. This Resolution changes important aspects of CVM Resolution No. 80, applicable to all companies that are registered before the agency – which is also a requirement for an initial public offering – and provides that companies present, in their reference form, their main indicators of ESG aspects, as well as their ESG risks. In addition, they must disclose whether they have an inventory of greenhouse gas emissions and provide information regarding the diversity of their body of administrators and employees.

On 20 October 2023, the CVM issued Resolution No. 193. This Resolution makes Brazil the first country to adopt International Sustainability Standards Board (ISSB) standards for the preparation and disclosure of sustainability-related financial information by publicly held companies, investment funds and securitisation companies. Seeking to align local practices with the most sophisticated sustainability information disclosure practices worldwide, the CVM has listed the principles it followed in the resolution itself.

The ISSB was created by the IFRS Foundation, an international organisation that has developed the most widely accepted accounting standards worldwide. Established at COP26 in November 2021, the ISSB aims to create a high-level benchmark for sustainability disclosures that focuses on the needs of investors and other actors in financial markets.

The new resolution also comes in the wake of a recent recommendation from the International Organization of Securities Commissions (IOSCO). This organisation seeks to harmonise the disclosure of sustainability-related information, particularly about assessing risks and opportunities, promoting an effective and proportional global framework that is interoperable at the international level.

Also, voluntary initiatives exist in Brazil, such as the green economy methodology developed with the support of Fundação Getulio Vargas and the United Nations Environment Programme (UNEP) Inquiry, based on UNEP's green economy definition.[2] Furthermore, Febraban is revising the methodology to develop a taxonomy that would help improve the identification of green activities, as well as sectors highly exposed to climate and environmental risks. The BCB is also analysing how to adopt a classification system to identify the exposure of credit portfolios to environmental and social risks. In this regard, its latest financial stability report presents a version of this system, which is being improved. The under-review Febraban taxonomy and the list of high-risk sectors provided by the World Bank[3] are among the resources currently being considered.

An environmental and sustainable-focused taxonomy will provide investors with information and ensure transparency on sustainable investments. Participants in the market, given the non-existence of guidelines setting forth the requirements for an investment to be considered sustainable, can currently deal with products and services under the label of sustainability that do not fulfil the specific requirements.

ESG data, ratings and reporting

Investors, companies, and participants in the market are increasingly concerned about the fulfilment of sustainable investments with regard to the relevant requirements. Under Brazilian regulation, there are certain requirements that aim at covering the disclosure of information on aspects of ESG, including information subject to disclosure by:

1. publicly held companies under their periodic reference forms, because of the CVM's regulation; and
2. financial institutions, such as banks, in view of the regulations recently issued by the BCB.

The Brazilian legal framework has yet to establish reporting requirements when it comes to sustainable investments, including coverage of the level of emissions by companies and requirements for ESG data and rating providers. However, the participants in the negotiation of the transaction documents usually set forth obligations therein to have evidence that the funds received in the offerings and transactions have been allocated by the companies to green and sustainable projects; in addition rating agencies establishes their own requirements for providing the rating, which are usually aligned with markets practices used worldwide.

Additionally, the ESG data reporting regime has been challenging, mainly because: not all companies are required to disclose this information; and the Brazilian legal framework has yet to set forth all the requirements applicable to sustainable investments. Furthermore, it is not mandatory that financial entities produce ESG transition plans, since the Brazilian legal framework does not provide any determination in this regard.

Sustainable finance incentives

There are no specific ESG government incentives; however, there are a few mechanisms that support investment in sustainable projects, even if only indirectly. Considering tax matters, it is important to highlight Law No. 12,431/11, which seeks to encourage the development of projects by reducing the applicable tax burden on the interest derived from debentures and investment funds whose fundraising was intended for investment projects.

In 2020, the government expanded the definition of investment projects set forth in Law. No. 12,431/11 by means of Decree No. 10,387/20. With the enactment of Decree 10,387/20, the investment and debentures encouraged by Law 12,431/11 encompass projects that provide relevant benefits to environmental or social matters. The main goal is that this measure can foster the development of the securities green market and fixed income securities whose resources are destined for carrying out projects or investing in assets that have positive climate or environmental impacts, and social securities. It is worth noting that Decree No. 10,387/20 also defines which projects cause 'relevant environmental or social impacts', moving towards defining something more specific to ESG matters. Among such projects, it is important to mention urban transport systems, including railways, and renewable solar energy generation.

It is also important to mention the incentives applicable to ESG operations, under which the issuer gains a few benefits by complying with some ESG criteria. In the green bonds structure, for example, it has become more common to provide better rates to the issuer linked to the accomplishment of key ESG performance indicators.

Furthermore, the CVM has begun to demand that listed companies disclose their ESG information, followed by the Brazilian stock exchange, which issued some rules in this regard, as it did with the compliance requirements created within the context of the new market landmark, a few years ago, when compliance requirements increased all over the world.

Carbon markets and carbon trading

Brazil has been actively involved in carbon trading, both through mandatory and voluntary mechanisms.

Under the mandatory carbon trading regime, there is the Clean Development Mechanism (CDM) and renewable energy auctions. Brazil, as a signatory to the Kyoto Protocol, has participated in the CDM. The CDM allows developed countries to invest in emission reduction projects in developing countries and receive carbon credits in return. Brazil has also implemented renewable energy auctions that include mechanisms to trade carbon credits. Projects in renewable energy, such as wind and solar, can generate carbon credits that can be traded within these auctions.

As to voluntary carbon trading, the Verified Carbon Standard (VCS) is a widely recognised voluntary standard for carbon offset projects. Brazilian projects can follow VCS protocols to generate verified carbon credits, which can be traded in the voluntary market. Similar to VCS, the Gold Standard is a voluntary certification standard for carbon offset projects. Brazilian projects adhering to Gold Standard criteria can produce certified carbon credits for voluntary trading.

Brazil's carbon markets have demonstrated maturity, especially in the context of the CDM. The country has been a significant participant in global carbon trading initiatives. However, the maturity level may vary across different sectors and voluntary market segments.

However, the carbon market also faces difficulties. Changes in government policies and regulations can create uncertainty for carbon market participants, impacting investment decisions. Additionally, Brazil faces challenges related to deforestation, which can impact the overall carbon balance. Sustainable land use practices and policies are crucial for the effectiveness of carbon markets. Additionally, carbon credit prices can be volatile, impacting the economic viability of projects. This volatility may be influenced by global market dynamics, policy changes and external factors.

The challenge of integrating Brazilian carbon credits with other markets can arise due to differences in standards, methodologies and regulatory frameworks. Harmonisation efforts are necessary for seamless trading. Increasing the involvement of both public and private sectors in carbon markets is essential for scaling up initiatives. Public awareness and participation can drive demand for voluntary credits. Collaboration with international partners is crucial for the success of carbon markets. Issues related to international cooperation, such as alignment with global standards and agreements, need continuous attention.

Brazilian carbon credits can potentially be used in international markets, depending on the type of credits, and the compatibility with other market standards. Issues concerning the acceptance and recognition of credits in different markets may pose challenges and require ongoing negotiation and coordination.

Green technology

Emerging technologies, especially hydrogen, carbon capture utilisation and storage, ammonia and batteries are increasingly influencing sustainable finance investments globally, including in Brazil. These technologies play a significant role in the transition to a more sustainable and low-carbon economy. While the influence of these technologies on sustainable finance in Brazil is subject to the country's specific circumstances and policies, there are notable trends and considerations.

The federal government recently announced a series of decrees that will support the development of green investments and the reduction of greenhouse gas emissions. In this scenario, trading of emerging technologies has been increasing in the past few years in Brazil, following the global trend and legislative innovations. Regarding carbon trading, Decree No. 11,075, among other matters, instituted the National System for the

Reduction of Greenhouse Gas Emissions and created a national system whose purpose is to serve as a single centre for recording emissions, removals, reductions, and offsets of greenhouse gases and acts of trade, transfers, transactions and retirement of certified emission reduction credits.

While the influence of these emerging technologies on sustainable finance in Brazil is promising, challenges such as regulatory uncertainties, market dynamics and the need for infrastructure development must be addressed to unlock the full potential of sustainable finance in these sectors. Continuous monitoring of policy developments and market trends will be essential for investors and stakeholders in navigating the evolving landscape of sustainable finance in Brazil.

Climate change, nature and biodiversity impacts

Considering that the ESG agenda is constantly increasing, even more companies are seeking alternatives and adopting measures to benefit the environment or are committed to finding new ways to approach the matter within their daily activities.

Brazil has faced both successes and challenges in meeting its climate and nature-related targets. However, since there are no specific rules in the Brazilian legal framework concerning climate change, there are no associated rules-based litigation or enforcement actions, although there are several lawsuits indirectly concerning the matter, as there are lawsuits over misconduct that is not in accordance with environmental law and rules.

As to deforestation and land use, Brazil has made progress in reducing deforestation rates, particularly in the Amazon region. There were periods of success in enforcing environmental regulations and implementing policies to combat illegal logging and land clearing. Despite progress, deforestation rates have fluctuated, and challenges persist, including illegal logging, agricultural expansion and enforcement issues.

When it comes to renewable energy, Brazil has a substantial share of renewable energy in its energy matrix, with a strong focus on hydropower, biofuels and increasing investments in solar and wind energy. However, the energy sector faces challenges over grid integration, intermittency of renewable sources and the need for further diversification. Balancing the energy mix to reduce reliance on large hydropower projects is an ongoing challenge.

Similarly, Brazil's environmental enforcement agencies have faced challenges in enforcing regulations, especially in remote areas. Changes in climate policies, including regulations on deforestation and emissions, can pose transition risks for businesses, particularly those heavily reliant on high-carbon activities. The transition to a low-carbon economy may impact industries such as energy, transportation and manufacturing.

The climate and transition risks are constantly debated in Brazil, considering the unique specifications of nature in Brazil. The advancement of some sectors of the economy has aggravated some issues already faced by the authorities, such as deforestation, irregular emission of gases in the atmosphere and pollution of rivers and lakes. However, the improvement of environmental legislation has emerged as a promising way for discussing environmental issues and finding solutions, above all because it is clear that the authorities are increasingly attentive to these aspects and state that they are committed to making their best efforts to guarantee the improvement of the relationship between market participants and the environment.

Greenwashing and climate litigation risks

The development of ESG discussions has also raised new concerns about the topic, greenwashing being an example of them. The regulators are closely looking at issues around greenwashing and thinking of alternatives to avoid it. In this regard, the CVM's Sustainable Financial Policy included in its agenda the development of measures to supervise and avoid greenwashing, by means of: (1) increasing investor awareness regarding the incorporation of ESG factors into their investment decisions; (2) increasing critical thinking and the ability to process ESG information to combat greenwashing; and (3) education as an alternative preventive protection for investors, among others actions to be taken from 2023 to 2024.

Beyond the measures that are still under analysis and pending formulation from the regulators, it is possible to state that increased supervision and control of requirements to avoid the practice of greenwashing in sustainable finance is already a trend and is among the main concerns of regulators.

At this point, climate litigation is not common in Brazil. However, lawsuits concerning damage suffered due to environmental matters are emerging and are tending to get more sophisticated as legislation on the matter is developing.

Outlook and conclusions

It is possible to conclude that ESG matters are highlighted on the agenda of the government and its bodies. Despite the several laws near to enactment, other resolutions and policies were issued aiming at improving ESG matters in the Brazilian market, in accordance with the development noted worldwide.

As expected, because of the recently enacted regulations, there has also been lots of interest in sustainable financing, resulting in new ESG regulations being issued in the short term.

All in all, we shall see regulatory innovation and sophistication in this regard in the coming years.

Endnotes

1 Tiago Araujo Dias Themudo Lessa and Rafael José Lopes Gaspar are partners and Renata Gaspar Barbosa Corrêa and Victor Galembeck Ahern Miranda are associates at Pinheiro Neto Advogados. ^ Back to section

2 UNEP Green Economy: https:// www.unep.org/explore-topics/greeneconomy. ^ Back to section

3 GIZ (2020). O mercado emergente de finanças verdes no Brasil. Available at: http://www.labinovacaofinanceira.com/wpcontent/uploads/2020/07/mercado_f i nancasverdes_brasil.pdf. ^ Back to section

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Introduction

In Canada, sustainable finance has developed within the voluntary frameworks and best practices developed through the International Capital Market Association's (ICMA) Green Bond Principles, Sustainability-Linked Bond Principles, Social Bond Principles and the *Climate Transition Finance Handbook*. There is broad market acceptance of the various sustainable finance instruments contemplated within these frameworks.

Growing market understanding of the importance of environmental, social and governance (ESG) considerations to stakeholders has led more companies to adopt voluntary sustainability disclosure frameworks, such as the Task Force on Climate-Related Disclosures (TCFD), but also others, as part of their regular disclosure, which, in turn, has facilitated the utilisation of sustainable financing instruments. More and more companies are adopting net-zero emissions targets in line with Canada's national commitments, including Canada's largest banks.

More regulation around ESG disclosure and sustainable finance is on the horizon, however. The federal government in Canada has recognised the potential for driving emissions reductions through climate-related regulatory requirements in the financial sector. Guidelines have been issued for federally regulated financial institutions, and additional proposed regulations are out for consultation. In response to the adoption of various voluntary ESG disclosure frameworks and different approaches to making those disclosures, the Canadian Securities Administrators (CSA) have issued proposed climate-related disclosure rules for public companies in an effort to standardise the disclosure approach, based on some of the principles from the TCFD. Following the release on 26 June 2023 by the ISSB of its climate-related disclosure standard and its general standard for sustainability-related financial information, the CSA announced its intention to conduct further consultations to adopt disclosure standards based on the ISSB standards with appropriate modifications for the Canadian context.[2] Rules have been clarified on disclosures by ESG funds.

Year in review

There have been a number of significant developments in Canada over the past year concerning sustainable finance.

Following Canada's issue of a C$5 billion green bond in early 2022, the Province of Quebec and the Province of Ontario have issued additional green bonds.

In July 2022, Ontario Power Generation Inc issued its second green bond with a use of proceeds including the development of nuclear power, demonstrating market acceptance of nuclear as 'green'.

Additional corporate issuers of green bonds during late 2022 and early 2023 include TransAlta, Innergex Renewable Energy and Brookfield Renewable Partners.

The trend of financial corporates issuing sustainable bonds has continued, including by iA Financial, OMERS Financial Trust and National Bank of Canada.

The Office of the Superintendent of Financial Institutions (OSFI) released its Guideline B-15: Climate Risk Management (the Guideline), which establishes a climate-sensitive prudential framework applicable to all federally regulated financial institutions (FRFIs).[3]

In September 2022, the Sustainable Finance Action Council issued its 'Taxonomy Roadmap Report'.[4] The stated primary purpose of the report is to mobilise finance for sustainable growth by defining green and transition investment, but the report also proposes that the methodology in the report could be used as a standardised tool to benchmark climate and transition activities. As a discussion document, it is being reviewed by the Canadian federal Minister of Finance and the Minister of Environment and Climate Change.[5]

Following the release on 26 June 2023 by the ISSB of its climate-related disclosure standard and its general standard for sustainability-related financial information, the CSA announced its intention to conduct further consultations to adopt disclosure standards based on the ISSB standards with appropriate modifications for the Canadian context.-[6] In 2021, the CSA published a proposed National Instrument 51-107 Disclosure of Climate-Related Matters and its proposed Companion Policy 51-107CP for comment.[7]

Regulation and policy

i Governance regime

Canada is a party to the Paris Agreement[8] and so is required to prepare, communicate and maintain successive nationally determined contributions (NDCs),[9] being reports that communicate the actions a party will take to adhere to the Paris Agreement (e.g., reduce its greenhouse gas (GHG) emissions and build resilience to adapt to the impacts of rising temperatures).[10] NDCs are to be updated every five years, with each iteration to be more ambitious than the previous one.

Most recently, Canada submitted an updated NDC on 12 July 2021 (the Updated NDC).[11] The most significant change in the Updated NDC is a commitment to reduce emissions by 40 to 45 per cent below 2005 levels by 2030. This is a substantial increase of ambition beyond Canada's original NDC, which had targeted a 30 per cent reduction below 2005 levels by 2030. The Updated NDC also outlines various climate-related action plans and investments that the Canadian government will take to adhere to the Paris Agreement.

One of these items is the Canadian Net-Zero Emissions Accountability Act.[12] The Canadian Net-Zero Emissions Accountability Act is the legislation that enshrines Canada's commitment to net zero by 2050.[13] In particular, Section 6 states: 'The national greenhouse gas emissions target for 2050 is net-zero emissions.'[14]

The Net-Zero Emissions Accountability Act became law on 29 June 2021. Along with setting the 2050 target, the Net-Zero Emissions Accountability Act requires the Minister of the Environment to set national GHG emissions targets for each milestone year with a view to achieving net zero by 2050.[15] Each milestone target must be a progression from the previous one.[16] The Net-Zero Emissions Accountability Act provides that the 2030 GHG emissions target is Canada's NDC for that year under the Paris Agreement.[17] Therefore, the Net-Zero Emissions Accountability Act codifies Canada's NDC, which was updated in

2021, to set the target of reducing emissions by 40 to 45 per cent below 2005 levels by 2030.[18]

The Minister is also required to set plans for achieving each target and prepare at least one progress report for each milestone year no later than two years before the beginning of the relevant year.[19] The Net-Zero Advisory Body was also established pursuant to this Act. The role of the Advisory Body is to give advice on how Canada can achieve its goal of net-zero GHG emissions by 2050.[20]

Pursuant to the Net-Zero Emissions Accountability Act and other legislation, Canada's federal government has started to announce emissions reduction targets for various sectors, including oil and gas, power, transportation and agriculture, to align those sectors' emissions targets with those in Canada's Updated NDC. The exact application of these targets within industries is still being worked out, but those industries understand the direction of travel of government policy and, in turn, have been establishing their own net zero targets.

Directly relevant to sustainable finance is the 2022 introduction of Bill S-243[21] (the Bill), which would enact the Climate-Aligned Finance Act, for a first reading of the Senate on 24 March 2022. Before the Bill can become law, it will be debated at the second reading of the Senate, studied by a parliamentary committee, debated at a third reading of the Senate and then voted on. If the Bill passes the vote at the third reading of the Senate, it will go through the same process in the House of Commons.[22] It is fair to say that the actual enactment of this Bill into law is somewhat uncertain in terms of both timing and eventual content, but it is indicative of the federal government's approach and of its understanding of using the levers available to it to drive certain behaviours in the financial sector.

The purpose of the Climate-Aligned Finance Act is to require certain financial and other federally regulated entities to mitigate and adapt to the impacts of climate change.[23-] The Climate-Aligned Finance Act is structured to align with and support the climate commitments that Canada has made under, among other agreements and commitments, the Paris Agreement[24] and the Net-Zero Emissions Accountability Act.[25]

The Act would require, among other things:

1. disclosures, for example:
    - 'reporting entities' (defined below) must publicly report their plans and targets;[26] and
    - a 'federal financial institution' (as defined below) must disclose how it 'financially facilities'[27] entities in a manner that either aligns or does not align with climate commitments;[28]
2. creation of policy, for example:
    - the Superintendent of Financial Institutions must establish guidelines to account for climate-related risks for banks and certain other entities regulated by the Bank Act;[29] and
    - the creation of an action plan to incentivise financial products that support climate commitments and disincentivise those that are inconsistent with climate commitments;[30] and

3. climate corporate governance, for example:
   - certain enumerated entities must appoint board members with 'climate expertise';[31] and
   - directors, officers or administrators of 'reporting entities' (as defined below) exercise their powers in a way that enables alignment with climate commitments.[32]

A 'reporting entity' includes 'federal financial institutions' (as defined below), along with (1) a corporation within the meaning of the Canada Business Corporations Act; (2) a work, undertaking or business within the legislative authority of Parliament that is described in any of Paragraphs (a) to (e) or (j) of the definition of 'federal work, undertaking or business' in Section 2 of the Canada Labour Code; and (3) an entity listed in Schedule III of the Financial Administration Act.[33]

A 'federal financial institution' includes, among other entities: (1) the Bank of Canada; (2) a bank within the meaning of the Bank Act; (3) the Canada Infrastructure Bank; (4) the Canada Deposit Insurance Corporation; (5) the Canada Mortgage and Housing Corporation; (6) Export Development Canada; (7) Farm Credit Canada; and (8) the Canada Pension Plan and the Canada Pension Plan Investment Board.

The Act would also provide the Superintendent of Financial Institutions to make any order they consider appropriate to certain federal financial institutions if, in their opinion, doing so is in alignment with climate commitments.[34]

More specific climate-related disclosure requirements that would apply to all FRFIs have been issued by OSFI.[35] Together with commitments banks have made within the NZBA, these disclosure requirements are expected, over time, to incentivise the use of sustainable finance instruments.[36]

The CSA have proposed climate-related disclosure rules that would apply to public companies in Canada.[37]

ii Regulators

At the time of writing, in Canada, sustainable finance frameworks are voluntary and market-driven. Issuers and banks reference the frameworks established by the ICMA, including the Green Bond Principles, the Social Bond Principles, the Sustainability-Linked Bond Principles and the *Climate Transition Finance Handbook*.

Efforts are under way to develop a 'made in Canada' transition financing taxonomy, pursuant to recommendations of an expert panel on sustainable finance.[38] An overview of the Sustainable Finance Action Council (SFAC)'s proposed taxonomy will follow; however, at the time of writing, the taxonomy has not been finalised. As such, any offering in Canada of securities labelled pursuant to one of the sustainable finance labels is regulated by generally applicable securities laws.

Sustainable finance instruments

Generally, all types of sustainable finance are supported in Canada, including green, social, sustainability and sustainability-linked loans and bonds.

In the Canadian market, it is generally understood that green loans and bonds can be issued by issuers whose business involves fossil fuels, though the use of proceeds cannot be fossil fuel-related (see, for example, Capital Power Corporation's green bond framework). Issuers in these types of industries can issue green bonds and use the proceeds to develop green and renewable power projects, for example, to transition their businesses towards renewable power. Canada has issued a C$5 billion tranche of green bonds. The eligible use of proceeds are terrestrial and aquatic biodiversity conservation, sustainable water management, sustainable management of living natural resources, renewable energy, pollution prevention and control, energy efficiency, eco-efficient products, production technologies and processes, climate change adaptation and clean transportation (see also Ontario Power Generation Inc's green bond issuance where the proceeds have been used to refurbish nuclear power generation facilities).

The Province of Quebec and the Province of Ontario also have issued green bonds, as has the City of Toronto. Other corporates that have more recently issued green bonds include TransAlta, Innergex Renewable Energy and Brookfield Renewable Partners.

Companies in traditional fossil fuel-related businesses have used sustainability-linked products with key performance indicators (KPIs) including emissions and emissions intensity (see, for example, Enbridge Inc's sustainability-linked bond framework and Tamarack Valley Energy Ltd's sustainability-linked bond framework). Enbridge Inc's sustainability-linked financing framework includes a target of reducing Scope 1 and 2 GHG intensity by 35 per cent by 2030 relative to 2018. Tamarack Valley's sustainability-linked financing framework includes the target of reducing Scope 1 and 2 emissions intensity by 39 per cent by 2025 over the 2020 baseline.

The Canadian market has seen the issuance of use of proceeds social bonds. For example, the City of Toronto has issued several tranches of social bonds where the use of proceeds is social and affordable housing, affordable basic infrastructure, access to essential services and socioeconomic advancement and empowerment. Other social bond examples include issuance into Canada by the International Finance Corporation where the use of proceeds was for benefiting underserved communities in emerging markets, including women entrepreneurs and low-income people in need of access to healthcare and essential infrastructure.

Sustainability bonds have been issued in Canada with broad ESG use of proceeds objectives. These typically have been issued by banks with the use of proceeds dedicated to certain uses. The Toronto Dominion Bank issued a sustainability bond with use of proceeds being access to essential services; affordable basic infrastructure; affordable housing; clean transportation; employment generation, including through the potential effect of small and medium-sized enterprise (SME) financing and microfinance; energy efficiency; green buildings; pollution prevention and control; renewable energy; socioeconomic advancement and empowerment; sustainable management of living natural resources; and sustainable water management. ScotiaBank issued a sustainability bond with a use of proceeds being terrestrial and aquatic biodiversity conservation; sustainable water management; sustainable management of living natural resources; renewable energy; pollution prevention and control; green buildings; energy efficiency; employment generation, including through the potential effect of SME financing and microfinance; clean transportation; affordable housing; affordable basic infrastructure; and access to essential services. A portion of the proceeds of the ScotiaBank bond was dedicated to support the Scotiabank Women Initiative, which was intended to help promote businesses owned and led by women. Other recent issuances of sustainable bonds include OMERS Financial Trust, iA Financial and National Bank of Canada.

Companies have also established social and governance-based KPIs and targets for sustainability-linked bonds and loans. Enbridge Inc's sustainability-linked financing framework includes Enbridge's racial and ethnic diversity performance target to boost racial and ethnic diversity to 28 per cent by 2025 from the current 21 per cent level. The framework also includes a target related to achieving 40 per cent female board representation by 2025. Tamarack Valley Energy's sustainability-linked bond includes a target of increasing indigenous workforce participation to 6 per cent or greater by 2025.

Drafting of sustainable finance provisions is still developing but is tending to follow international models.

Sustainable disclosure requirements and taxonomy

At the time of writing, there are limited legally mandated sustainability disclosure requirements.

At the time of writing, there are limited legally mandated sustainability disclosure requirements.

i Diversity disclosure

The principle legal requirements concern mandatory diversity disclosure by public companies. For example, since 2014, companies listed on the Toronto Stock Exchange (TSX) have been required to make diversity-related disclosures in their annual disclosure documents on a 'comply or explain' basis, including:

1. on their policies and targets regarding the representation of women on the board of directors and in executive positions; how representation of women is taken into account in selecting board and executive officer candidates;
2. gender representation on the board and in executive officer positions; and
3. term limits.[39]

See also National Instrument 58-101 (NI 58-101) of the CSA Disclosure of Corporate Governance Practices.[40]

Public corporations governed by the Canada Business Corporations Act have been required to make diversity-related disclosure regarding women, indigenous peoples, persons with disabilities and members of visible minorities (designated groups) since 2020 on a comply or explain basis.[41] These requirements include disclosure of term limits or other board renewal mechanisms, a description of written diversity policies for the selection of individuals from the designated groups as board nominees and a description of progress made in achieving the policy's objectives, whether the level of representation of designated groups on the board or in senior management is considered in appointing new candidates, whether targets have been established for representation of the designated groups on the board and in senior management, as well as progress towards those targets, and the number of members of each of the designated groups on the board and in senior management. New guidelines for making this disclosure were published by Corporations Canada in February 2022.[42]

Increasingly, governance ratings organisations and industry groups developing best practices are focusing on gender and other diversity measures as critical elements of measuring or rating corporate governance (see, for example, the Canadian Coalition for Good Governance and The Globe and Mail Board Games).

On 13 April 2023, the CSA issued a notice and request for comment, proposing amendments to NI 58-101 and National Policy 58-201 Corporate Governance Disclosure with revised disclosure requirements in respect of board and executive diversity, including in respect of women, indigenous peoples, racialized persons, persons with disabilities and LGBTQ2SI+ persons, board renewal and board nominations.[43] The CSA continue to consider whether the diversity disclosure model should move from comply or explain to mandatory disclosure around certain diversity categories.

ii Climate-related disclosure

On 18 October 2021, the CSA published a proposed National Instrument 51-107 Disclosure of Climate-Related Matters and its proposed Companion Policy 51-107CP (Climate Disclosure Proposals) for comment.[44] The proposed instrument would apply to public companies in Canada, regardless of jurisdiction of incorporation. For TSX-listed corporations with 31 December year ends, the proposed rules would take effect for annual filings made in early 2024.

Canadian companies have started to make voluntary disclosure of climate-related matters following the various voluntary frameworks and standards. Companies have adopted different approaches to the location, style and content of their disclosure, and one of the stated aims of the CSA proposals is to bring some standardisation to the disclosure to allow greater comparability for investors.

The Climate Disclosure Proposals would require disclosure based on recommendations of the TCFD. The Climate Disclosure Proposals would require issuers to make disclosure in the following areas:

1. governance: describing the board's oversight of climate-related risks and opportunities and management's role in assessing and managing climate-related risks and opportunities;
2. strategy: describing any climate-related risks and opportunities identified over the short, medium and long term, and describing the impact of these risks and opportunities on its business, strategy and financial planning;
3. risk management: describing its processes for identifying, assessing and managing climate-related risks and how these processes are integrated into overall risk management; and
4.

metrics and targets: describing its metrics used to assess climate-related risks and opportunities and targets used to manage these risks and opportunities.

The TCFD contemplates that issuers should disclose GHG emissions (Scope 1, 2 and 3). The Climate Disclosure Proposals would require issuers to make this disclosure or explain why they do not. The Climate Disclosure Proposals would not require issuers to disclose the resilience of their strategy with reference to various climate scenarios – a key element of the TCFD recommendations.

Subsequent to the release of the Canadian proposals, the US Securities and Exchange Commission (SEC) released its own proposal on the same disclosure area, and the International Sustainability Standards Board (ISSB) released two disclosure proposals on sustainability and climate change disclosure. Both the SEC's and the ISSB's proposals went further than the CSA proposals in a number of areas. On 12 October 2022, the CSA announced that it was actively considering the impact of international developments including the ISSB and SEC proposals on its climate-related disclosure proposals.[45] On 26 June 2023, the ISSB published its climate-related disclosure standard as well as its general standard for sustainability-related financial information, intended as a 'global baseline' with the approval of the International Organization of Securities Commissions. Following the release of these two standards, on 5 July 2023, the CSA announced its intention to conduct further consultations to adopt disclosure standards based on the ISSB standards with appropriate modifications for the Canadian context.[46] While the CSA has not announced what those modifications might be, in its submissions to the ISSB on its standards, the CSA recommended that climate-related standards should be developed first, with general sustainability standards in the future, that disclosure standards should be phased in and scaled to accommodate smaller issuers, that industry-specific guidance should be provided that initially would not be mandatory and that disclosure standards should be aligned internationally. At the time of writing, it is unclear when the CSA will publish an updated version of its climate-related disclosure proposals.

iii ESG-related investment fund disclosure

On 19 January 2022, the CSA released Staff Notice 81-334 ESG-Related Investment Fund Disclosure (the Notice) to provide guidance on the disclosure practices of investment funds as they relate to ESG considerations.[47] The issuance of the Notice follows a considerable increase in interest in ESG investing in Canada for both retail and institutional investors.

The CSA have emphasised that the guidance provided in the Notice is based on existing securities regulatory requirements and does not create any new legal requirements or modify existing ones. Rather, the Notice clarifies and explains how the current securities regulatory requirements apply to ESG-related investment fund disclosure, with the view of enhancing and bringing greater clarity to ESG-related disclosure and sales communications to enable investors to make more informed investment decisions.

An increase in ESG interest among investors, as well as the potential for 'greenwashing', whereby a fund's disclosure or marketing intentionally or inadvertently misleads investors about ESG-related aspects of the fund, are cited in the Notice as having led securities regulators and international organisations to directly address issues relating to ESG investing. Notably, the International Organization of Securities Commissions published a final report in November 2021, setting out recommendations for securities regulators and policymakers to improve sustainability-related practices, policies, procedures and disclosure in the asset management industry. In the same month, the CFA Institute published its Global ESG Disclosure Standards for Investment Products with the aim of providing greater transparency and comparability to investors by facilitating clear communication of ESG-related features of investment products from asset managers.

In Canada, the CSA have conducted continuous disclosure reviews of regulatory disclosure documents and sales communications of ESG-related funds. The findings of these reviews are summarised within the Notice. Although the CSA consider current disclosure requirements to be broad enough in scope to address ESG-related disclosure, in their view, additional guidance was needed to clarify how the current disclosure requirements apply to improve the quality of ESG-related disclosure and sales communications.

The Notice sets out guidance on how existing securities regulatory requirements apply to investment funds as they pertain to ESG considerations in the following areas.

Investment objectives and fund names

Under securities laws, an investment fund (in its prospectus) is required to disclose the fundamental investment objectives of the fund, as well as information that describes the fundamental distinguishing features of the fund. To prevent greenwashing, a fund's name and investment objectives should accurately reflect the extent to which the fund is focused on ESG and, where applicable, the particular ESG-related aspects the fund is focused on. To ensure consistency, where a fund's name references ESG, the fundamental investment objectives of the fund are required to reference the ESG-related aspect included in the name.

Fund types

Non-exchange traded mutual funds are required to identify the type of mutual fund that the fund is best characterised as in its prospectus. In the CSA's view, where a fund does not include ESG considerations in its investment objectives, it should not characterise itself as a fund focused on ESG, and, conversely, where ESG considerations are so included, a fund may characterise itself as a fund focused on ESG.

Investment strategies disclosure

The Notice sets out guidance for investment strategies disclosure applicable to all funds and specific guidance applicable only to funds that use any of the following: (1) proxy voting or shareholder engagement as an ESG strategy; (2) multiple ESG strategies; and (3) ESG ratings, scores, indices or benchmarks.

Guidance applicable to all funds

An investment fund is required to provide full, true and plain disclosure of all material facts in its prospectus. To enable investors to understand the ways in which a fund will meet its ESG-related investment objectives, where applicable, and make investments, full, true and plain ESG-related investment strategies disclosure must be made. ESG strategies, if used either principally or as part of its investment selection process, require disclosure of the ESG-related aspects of the fund's investment selection process and strategies. Description of these strategies must be written using plain language.

Further, the CSA take the view that investment strategies disclosure should identify the ESG factors used and explain their respective meanings, as well as how they are evaluated and monitored.

Guidance applicable to certain funds only

Funds that use proxy voting or shareholder engagement as a strategy to select investments are required to disclose how they are used by the fund. In the CSA's view, disclosure should include the criteria used by the strategy, the goal of the strategy and the extent of the monitoring process used to evaluate progress towards such goal.

If multiple ESG strategies are used, disclosure explaining how the different strategies are applied during the investment selection process is required. In addition, if the strategies are not applied simultaneously, disclosure must include the order in which they are applied.

In the CSA's view, where an ESG-related fund uses ESG ratings, scores, indices or benchmarks as part of its principal investment strategies or investment selection process, disclosure in relation to how these ratings, scores, indices or benchmarks are used should be provided.

Proxy voting and shareholder engagement policies and procedures

An investment fund that uses proxy voting as an ESG investment strategy must include a summary of the ESG aspects of the fund's proxy voting policies and procedures in the fund's prospectus or annual information form, as applicable. This inclusion can provide clarity about how voting rights will be used to further the fund's ESG investment objectives.

Further, the CSA encourage investment funds that use shareholder engagement as an ESG strategy to make their shareholder engagement policies and procedures publicly available to achieve greater transparency for investors.

Risk disclosure

In keeping with the requirement for a fund to disclose any material risks associated with an investment in the fund, the CSA encourage all investment funds to consider whether any material ESG risk factors are relevant to the fund and to disclose these risk factors, if applicable.

Suitability

As mentioned above, a fund's name and investment objectives should accurately reflect the extent to which the fund is focused on ESG. Similarly, the CSA highlight that brief statements of a fund's suitability for particular investors should also accurately reflect the extent of the fund's focus on ESG and any particular aspects of ESG that the fund is focused on.

Continuous disclosure

Funds that have ESG investment objectives can help prevent greenwashing by providing useful continuous disclosure that allows investors to monitor and evaluate the fund's ESG performance. ESG-related funds are required to disclose how the composition of the investment portfolio relates to the fund's ESG investment objectives or strategies, as applicable, in its management reports of fund performance. Further, the CSA encourage funds with a measurable ESG outcome to report whether the outcome is being achieved in the same reports. Investment fund managers are also encouraged to regularly assess, measure and monitor the ESG performance of the funds they manage, to ensure that useful disclosure is provided.

If a fund uses proxy voting as an ESG strategy to meet its ESG investment objectives, the fund is encouraged to include disclosure of all of the fund's annual proxy voting records on its websites, despite the current requirement that only the most recent annual proxy voting record be made available. The CSA take the view that this disclosure would provide greater transparency into how the fund has historically made use of proxy voting to meet its ESG considerations. For the same reason, funds that use shareholder engagement as an ESG strategy are also encouraged to provide disclosure of past shareholder engagement activities.

Sales communications

Sales communications containing ESG considerations must not be misleading or untrue and should be consistent with a fund's regulatory offering documents so as to not intentionally or inadvertently mislead investors about ESG aspects of the fund.

Sales communications indicating that a fund is focused on ESG

The extent to which a fund is focused on ESG should be accurately reflected in any sales communication pertaining to the investment fund. Further, the CSA believe that a fund should not indicate that it is focused on ESG in its sales communications unless ESG is referenced in its investment objectives.

Sales communications referencing a fund's ESG performance

A fund must not include misleading statements about ESG performance of the fund in its sales communications.

Sales communications including ESG ratings, scores or rankings

Similarly, sales communications that include fund-level ESG ratings, scores or rankings must not be misleading. In the Notice, the CSA provide specific guidance on how to avoid issues such as: (1) conflicts of interest involving the provider of the ESG rating, score or ranking; (2) cherry-picking ESG ratings, scores or rankings; (3) selecting ESG ratings, scores or rankings that are not representative of the ESG characteristics or performance of the fund; and (4) omission of necessary or appropriate explanations, qualifications or limitations.

ESG-related changes to existing funds

To the extent that any references to ESG are added or removed from the fundamental investment objectives of a fund, that fund will be subject to the requirement that approval of its security holders be obtained prior to the making of any change to the fund's fundamental investment objectives. If an investment fund changes its name to add or remove a reference to ESG, as mentioned above, similar consideration should be given to changing the fund's fundamental investment objectives.

ESG-related terminology

A fund's prospectus should provide a clear explanation of any ESG-related terms that are not commonly understood.

Investment fund manager-level commitments to ESG-related initiatives

If investment fund managers are signatories to certain international or regional ESG-related initiatives and publicly disclose this information, the CSA highlight the importance of clarifying that commitments to these initiatives are at the entity level, rather than at the fund level.

iv Proposed transition taxonomy

In May 2021, the federal government launched the Sustainable Finance Action Council (SFAC) to, among other things, develop a green and transition finance taxonomy for Canada. The Taxonomy Roadmap Report (the Taxonomy Report), which proposes a voluntary taxonomy to benchmark and standardise economic activities to align with Canada's climate commitments, was published by the SFAC in September 2022.[48]

The Taxonomy Report provides guidance on several transition finance-related objectives, including climate-related disclosures and the classification of financial instruments and related projects as 'green' or 'transition', or both.[49] The Taxonomy Report outlines a set of general requirements an issuer must abide by to support a credible transition plan. These requirements are: (1) setting a credible and science-based, net-zero emissions target for 2050 or earlier and an interim target for 2030 on the path toward net-zero, and preferably at least one more additional interim targets between 2030 and 2050 and using a 1.5C degree target; (2) report publicly on progress annually and review and update plans every five years; and (3) prepare climate-related disclosures for the public, basing them on the recommendations of the TCFD in the short-term, and then in compliance with emerging domestic regulatory requirements and international standards. All Scope 1, 2 and 3 emissions are to be considered. A number of principles are outlined in the report for assessing whether a particular activity is eligible for the 'transition' label. Generally these principles require assessing the proportionality of an activity's Scope 3 emissions against the expected decline in global demand for the activity's output (i.e., the extent of carbon lock in), and then assessing whether the activity significantly reduces Scope 1 and Scope 2 emissions and avoids supply side carbon lock in.

The Taxonomy Report also incorporates do no significant harm criteria, which is intended to be informed by the European Union criteria, but are adapted to meet unique Canadian needs. The specified criteria are a work in progress, but currently require that an activity complies with the following:

1. no significant harm to environmental outcomes: the activity must meet minimum requirements for water, biodiversity, pollution and waste impacts;
2. no significant harm to climate resilience: the activity incorporates best practices to reducing physical risk;
3. no significant harm to indigenous rights: the activity demonstrates adherence to the UN Declaration on the Rights of Indigenous Peoples; and

no significant harm to workers or just 's Deputy Prime Minister and Minister of Finance as well as the Minister of Environment and Climate Change for consideration and action in the autumn of 2022. To date, the Ministers have not provided their response. In the interim, the SFAC is directing the development of the taxonomy introduced in the Taxonomy Report with a focus on establishing voluntary issuance requirements and green and transition criteria for an initial set of priority sectors and activities. At this point, the status of the Taxonomy Report is unclear though it is expected that it will inform federal government policy.

v Federally regulated financial institutions

In March 2023, OSFI, which is the federal government agency that regulates and supervises FRFIs, issued 'Guideline B-15: Climate Risk Management', which specifies climate-related disclosure for FRFIs. See Section VII.

ESG data, ratings and reporting

At the time of writing, beyond FRFIs, mandatory reporting relating to sustainable investments is limited to diversity matters.[50] Broadly applicable industry-specific regulation can require reporting of various metrics to applicable regulators, and some of this reporting includes information relevant to sustainability topics. Some of this reporting is public and some is confidential. Since this type of reporting is not tied to sustainable investments, it is not dealt with further in this chapter. Its existence is relevant to note, however, since the argument for more sustainability disclosure is often based on the fact that disclosure is being made to regulators in any event.

Reporting relating to sustainable investments is being made by numerous companies on a voluntary basis. This disclosure is being made under voluntary frameworks and standards like the TCFD, or in the context of specific issuances in accordance with the relevant ICMA principles.[51] This has led to an environment where disclosure varies across companies in terms of location, content and style (and in some cases not at all), which, in turn, has led investors to push for mandatory disclosure requirements.[52]

Various proposals are being considered at the time of writing that would impose mandatory data and reporting requirements.[53] These proposals generally are intended to apply to public companies.

At the time of writing, there are no regulatory requirements that apply specifically to ESG ratings services.

Sustainable finance incentives

At the time of writing, there are no direct government incentives to use sustainable finance instruments. There are, however, indirect longer-term, market-based incentives developing to push companies towards adopting sustainable finance instruments. Major providers of capital in Canada will become subject to climate-related disclosure obligations that will incentivise those institutions to prefer to lend pursuant to sustainability-type financing instruments so that they are comfortable that their lending portfolios will, over time, represent lower GHG emissions. The most immediate disclosure obligations on the horizon are those in the OSFI climate risk management Guideline B-15 and commitments made by financial institutions that have signed on to the NZBA.

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i Guideline B-15

In March 2023, OSFI, which is a federal government agency that regulates and supervises FRFIs issued 'Guideline B-15: Climate Risk Management' (the Guideline). The Guideline applies to all FRFIs, with the exception of foreign bank branches[54] and sets out expectations the management of climate-related risks by FRFIs and imposes a mandatory climate-related financial disclosure framework for FRFIs. These Guidelines are broadly consistent with the climate-related disclosure standards published by the ISSB in June 2023.

Chapter 1 of the Guideline set out expectations to the governance and risk management of climate-related risks. Specifically, FRFIs are required to develop and implement a climate transition plan (the Plan) that both identifies physical and transitional risks related to climate change and addresses the FRFI's management and mitigation thereof.[55] To measure progress, performance metrics and targets are to accompany the Plan. In addition, FRFIs are expected to use climate scenario analysis and stress testing to evaluate the efficacy of business strategies and business models and to maintain sufficient capital and liquidity with which to buffer any climate-related risks.[56]

Chapter 2 of the Guideline establishes a mandatory climate-related financial disclosure regime. This chapter applies to all FRFIs in the scope of the Guideline, except for subsidiaries of FRFIs that report consolidated results to OSFI.[57] The minimum mandatory climate-related financial disclosure expectations are divided into four categories[58] as follows:

1. governance;
2. strategy;
3. risk management; and
4. metrics and targets

Governance disclosure expectations are to:

1. describe the board of director's oversight of climate-related risks and opportunities; and
2. state management's role in assessing and managing climate-related risks and opportunities.

Strategy disclosure expectations are to:

1. describe the climate related risks and opportunities the FRFI has identified over the short, medium, and long term.
2. state the impact of climate-related risks and opportunities on the FRFI's businesses, strategy, and financial planning.
3. describe the FRFI's Plan (implementation date to be determined); and
4. describe the resilience of the FRFI's strategy, taking into consideration different climate-related scenarios, including a scenario which limits warming to the level aligned with the latest international agreement on climate change, or lower (implementation date to be determined).

Risk Management disclosure expectations are to:

1. describe the FRFI's processes for identifying and assessing climate-related risks;
2. describe the FRFI's processes for managing climate related risks.
3. state how processes for identifying and managing climate related risks are integrated into the FRFI's overall risk management.

Metrics and targets disclosure expectations are to:

1. disclose the metrics used by the FRFI to assess climate-related risks and opportunities in line with its strategy and risk management (implementation date to be determined and eventually to be supplemented with (1) OSFI-specified prudential cross-industry metrics; and (2) OSFI-specified prudential industry-specific metrics);
2. disclose the FRFI's Scope 1 and 2 GHG emissions (absolute basis) for the period. If the reporting standard used by the FRFI is not the GHG Protocol Corporate

Standard, disclose how the reporting standard used by the FRFI is comparable with the GHG Protocol Corporate Standard;

3. disclose the FRFI's Scope 3 GHG emissions for the period (absolute basis) and the related risks. If the reporting standard used by the FRFI for Scope 3 emissions is not the Corporate Value Chain (Scope 3) Accounting and Reporting Standard, disclose how the reporting standard used by the FRFI is comparable with the Corporate Value Chain (Scope 3) Accounting and Reporting Standard. For financed, facilitated and insured Scope 3 GHG emissions, if the reporting initiative used by the FRFI is not the PCAF Standard, then disclose how the reporting initiative used by the FRFI is comparable to the PCAF Standard;
4. state the targets used by the FRFI to manage climate-related risks and opportunities and the FRFI's performance against these targets; and
5. disclose any public climate-related commitments, if the FRFI has made one or more, through an industry-led Net-Zero alliance (e.g., NZBA).[59]

Most of the Guideline disclosure requirements will be in effect for domestic systemically important banks (D-SIBs) and internationally active insurance groups headquartered in Canada at fiscal year end 2024, with other FRFIs to begin disclosures for fiscal year ends 2025 and 2026 in accordance with Annex 2-2 of the Guideline. Once the Guideline becomes effective, FRFIs are required to make applicable disclosures no later than 180 days after fiscal year end and must publish their relevant disclosures on an annual basis.

At some point, banks will be looking to their borrowers to provide information the banks will need to determine their Scope 3 GHG emissions.

ii NZBA

At the time of writing, eight Canadian institutions have joined the NZBA. The first Canadian member was Vancity, which became a founding signatory on 21 April 2021.[60] On 21 October 2021, the D-SIBs, being the Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada and Toronto Dominion Bank, also became NZBA signatories.[61] In the months that have followed, Coast Capital Savings, a credit union operating wholly in British Columbia, is the only other Canadian institution to join.

The NZBA was convened by the United Nations Environment Programme Finance Initiative. It represents a group of banks committed to aligning their lending and investment portfolios with net-zero emissions by 2050.[62] Two structures drive the NZBA's goal towards net-zero emissions. First, it establishes a platform for members to demonstrate leadership, consistency and credibility of action.[63] To this end, the NZBA provides a common standard for '1.5 degrees trajectory', which, in turn, enhances accountability to the commitment. Second, it provides a structured forum to support member transitions by showcasing potential implementation approaches, sharing experiences to accelerate progress and facilitating the transfer of resources, methodologies and leading practices.[64]

To join the NZBA, each bank must have its chief executive officer sign a commitment statement that describes the target-setting and reporting process said to be the primary catalyst for achieving the net-zero transition.[65] All signatories must commit to the following:

1. to transition the operational and attributable GHG emissions from their lending and investment portfolios to align with pathways to net zero by 2050 or sooner;
2. within 18 months of joining, to set 2030 targets (or sooner) and a 2050 target, with intermediary targets to be set every five years from 2030 onwards;
3. the banks' first 2030 targets will focus on priority sectors where the bank can have the most significant impact (i.e., the most GHG-intensive sectors within their portfolios), with further sector targets to be set within 36 months;
4. to publish absolute emissions and emissions intensity annually in line with best practice, and within a year of setting targets disclose progress against a board-level reviewed transition strategy, setting out proposed actions and climate-related sectoral policies; and
5. to take a robust approach to the role of offsets in transition plans.[66]

At the time of writing, seven of the eight the Canadian institutions that have joined the NZBA have met their commitment to set targets for 2030, which can be found online.[67]

Carbon markets and carbon trading

As more and more Canadian companies and organisations pledge to their consumers, stakeholders, investors that they will achieve net zero or reduce emissions, interest in participating in carbon markets to meet ESG goals has skyrocketed. In Canada, the implementation of carbon pricing mechanisms has been a key government strategy for addressing climate change and is receiving increased interest from investors as the benefits of emphasising the calculable reductions in carbon-intense activities are recognised. In particular, Canada's 'compliance' markets, where an emitter of GHGs is obligated to reduce its emissions to remain compliant with the regime, incentivises the development of clean technologies and the implementation of these technologies as best practices.[68] The compliance carbon markets in Canada employ various pricing mechanisms, including carbon taxes, cap-and-trade systems and hybrid approaches. Carbon taxes impose a fee on each ton of carbon emitted, incentivising emission reductions. Cap-and-trade systems set a limit on emissions and allow entities to trade emission allowances, promoting market-driven emission reduction efforts. Hybrid approaches combine elements of both systems to optimise effectiveness.[69]

The Province of Alberta, while being an early creator of a compliance regime and having a well-established, robust market, is more recently receiving substantial interest by ESG-focused investors and renewables developers due to its carbon offset creation protocols for renewables, pneumatics and carbon capture, usage and storage (CCUS). While participation in the Technology Innovation and Emissions Reduction Regulation[70] (TIER) is required by large-scale industrial facilities emitting 100,000 million tons or more of GHG emissions annually, there is also an opt in process for other facilities, which is increasingly being utilized by smaller emitters to measure, track and validate compliance. Options to meet a compliance include: (1) paying into the TIER fund; and (2) buying, or producing, emission offsets generated by facilities that voluntarily reduce or sequester GHG emissions – and retiring these offsets against one's obligations.[71]

] An Alberta-situated company can create emission offsets under the TIER programme if it does so in accordance with a wide range of approved protocols, creating an incentive to implement certain technologies or to invest in renewables. Credit usage is currently limited to 60 per cent of an emitter's compliance requirement for the 2023 compliance year, and will be raised by 10 per cent until it reaches 90 per cent in 2026.[72] Once those offsets are created, developers can sell them into the market – to an intermediary such as a broker or retailer or directly to a party wishing to retire the credits.

Quebec's cap-and-trade system for regulating GHG emission allowances has been in existence for over a decade. Since 1 January 2014, Quebec has linked the CITSS carbon credit market with California (where the governing body is the California Air Resources Board), forming the largest carbon market in North America.[73] Regulated emitters may only use offset credits to satisfy up to 8 per cent of their emission target.[74] However, the Quebec system, similar to Alberta, is open to non-regulated entities to participate and voluntarily opt in to participate in the purchase, hold, sale, transfer and withdrawal of emission allowances.

More recent and rapidly expanding markets are the British Columbia compliance market and the Federal CFR.

In British Columbia, compliance carbon credit trading and use is governed by the Greenhouse Gas Industrial Reporting and Control Act (GGIRCA)[75] and its associated regulations. The GGIRCA legislative regime creates an output-based pricing system for liquefied natural gas projects and facilities that produce 10,000 tonnes or more of carbon dioxide equivalent during a reporting period. Canada's Clean Fuel Regulations[76] (CFR) are a set of rules and requirements implemented by the federal government to reduce GHG emissions from the transportation sector. These regulations aim to encourage the use of cleaner fuels and technologies to mitigate climate change by implementing emission reduction strategies, supplying more low-carbon fuels and fuel switching. Obligatory as of 1 July 2023, the CFR take a life cycle approach to emissions calculations – taking into account the emissions associated with all stages of fuel production and use – from extraction through processing, distribution and end use.[77] The demand for CFR credits will ideally create a market signal for new and expanded investment in low carbon intensity fuels and technologies, including for voluntary parties such as biofuel producers and other lower carbon fuel producers to create and sell credits.[78] Similarly, CFR is intended to create opportunities for feedstock providers to produce low-carbon fuel.[79]

Enhancing investor education and awareness as to the role carbon markets can play in sustainable finance is essential to drive further investment in green projects. Opportunities to scale up investment in carbon-reducing or carbon-avoiding technologies in Canada will become increasingly available and given the obligatory nature of Canada's compliance markets, present a unique opportunity to participate in actual, measurable reductions or mitigations.

Green technology

Sustainable finance in Canada is being shaped by the significance of resource extraction, transportation and processing industries in the economy and the transition these industries are making to a lower carbon world.[80] The transition means, of course, that there are investments that fall squarely in the typical use of proceeds for green bonds. These include renewable power generation and green buildings.

However, many companies whose business involves fossil fuels see sustainability and sustainability-linked instruments as more aligned with their capital spending programmes that may include carbon capture utilisation and storage, efficiency projects and grey hydrogen, for example. Some of these companies that may not yet be perceived as strong sustainability actors have stayed away from issuing green bonds to avoid any risk of greenwashing allegations, even when they do have typical green spending plans.

Climate change, nature and biodiversity impacts

The regulatory framework around sustainable finance in Canada is in the developmental phase, and, at this point, the real impact of sustainable finance on climate change is an awareness that there is the potential for sustainable finance to have an impact on reducing GHG emissions and the achievement of other ESG targets.

Greenwashing and climate litigation risks

Regulators in Canada are looking at issues around greenwashing. The CSA has issued a staff notice identifying overly promotional disclosure pertaining to environmental, social and governance matters as a key area for improvement in issuers' continuous disclosure.[81] In particular, the CSA has noted that issuers need to ensure consistency between voluntary and required disclosures, and that some issuers are making potentially misleading, unsubstantiated or otherwise incomplete claims about environmental, social and governance matters and sustainability-related aspects of their business. In addition, numerous investigations and actions have been brought by the Competition Bureau of Canada concerning false or misleading representations and deceptive marketing practices by Canadian companies around environmental claims, including claims of carbon neutrality, assertions that natural gas is a 'clean' fuel and representations around emissions reductions by fossil fuel producers that do not take account of Scope 3 emissions.[82]

To date these regulatory concerns have not been positioned in the context of sustainable finance per se. There have been shareholder proposals and proxy solicitation battles at public company annual shareholder meetings targeting issuers' and banks' involvement in sustainable finance offerings where the particular industry sector has not been perceived as 'sustainable' or key performance indicators and targets have not been perceived as being sufficiently ambitious.

Climate litigation generally is continuing to develop in Canada but is still in its early days. Litigation has been brought against governments for taking insufficient action to protect the environment, and steps are being taken by certain municipalities to assemble budget funds for litigation against large carbon emitters. While in its infancy, climate litigation is expected to continue to grow, including based on the success of various claims in the United States and in the UK, and is considered a business risk.

Outlook and conclusions

Over the coming year, it is anticipated that many of the regulatory proposals around ESG disclosures and sustainable finance will have solidified or been adopted, in most cases contemplating prospective application. The regulatory road map around these issues will become clearer, though the direction of travel of regulation is understood to be well articulated in the proposals, which seems unlikely to change. This should facilitate the continuing development of sustainable finance in Canada as capital markets participants prepare for compliance timelines.

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Introduction

i The framework of sustainable finance in mainland China

While the regulators issued documents regarding green credit/green loans in the late 1990s and early 2000s, it was not until 2016 that a comprehensive framework of sustainable finance/green finance started to develop. This was the *Guiding Opinions on the Building of a Green Financial System*, jointly issued by seven ministries and commissions on 31 August 2016, which set out the framework of green finance in mainland China.

Currently, there are regulations covering different aspects of green finance, including green credit (loans), green bonds, green stocks, green funds, green insurance and the market for carbon emission rights trading. Most regulations are issued in the forms of notices, opinions and guidelines by various regulatory departments or agencies in charge of different sectors jointly or separately, from time to time, rather than being promulgated by the National People's Congress (NPC) or its Standing Committee in the form of permanent legislation. For example:

1. some banks are subject to the Green Finance Evaluation Plan for Banking Financial Institutions and banks and insurance institutions are subject to the Guidelines for Green Finance in Banking and Insurance Sectors and the Corporate Governance Guidelines for Banking and Insurance Institutions, both issued by the former China Banking and Insurance Regulatory Commission (CBIRC, now the National Administration of Financial Regulation (NAFR));
2. green bonds are subject to the Guiding Opinions on Supporting the Development of Green Bonds as well as the Catalogue of Projects Supported by Green Bonds issued by the People's Bank of China (PBOC), National Development and Reform Commission (NDRC) and China Securities Regulatory Commission (CSRC);
3. public funds are subject to the Opinions on Accelerating the High-quality Development of the Public Fund Industry;
4. the asset management sector has to refer to the non-mandatory Guidelines on Green Investment (for Trial Implementation) issued by the Asset Management Association of China (AMAC); and
5. listed financial institutions may also be subject to sustainable disclosure requirements of the CSRC and stock exchanges.

This low level of hierarchy of legislation and standardisation is commonly seen as a major issue in the regulatory framework of sustainable finance in China.

In January 2022, the PBOC, State Administration of Market Regulation (SAMR), CBIRC and CSRC jointly issued the 14th Five-Year Plan for Financial Standardisation, sending out a strong policy signal that the regulatory authorities are well aware of these drawbacks and are planning a more unified and standardised sustainable finance regime governed at higher levels of legislation.

ii Recent trend and market mood

The trend in sustainable finance in mainland China can best be summarised through the twin drivers of regulatory guidance and market self-motivation.

On the regulatory side, the PBOC's Green Finance Evaluation Plan for Banking Financial Institutions will incentivise large banks to develop sustainable finance businesses and establish appropriate systems and governance frameworks, thereby propelling the entire banking market to adopt similar practices. The Guidelines for Green Finance in Banking and Insurance Sectors and their supporting regulations require banks and insurance companies to pay attention to, and consider, risks in the process of investment and financing, by putting in place applicable internal management processes. This should ensure that banks and insurance companies impose higher standards and stricter requirements concerning sustainability factors of their investment targets. These requirements also set examples for other financial institutions to raise their expectations of, and attention to, the sustainability of investment targets.

On the market side, the emerging domestic and foreign ESG ratings, the requirements of ESG regulations in overseas jurisdictions on the entire supply chain, and the advocacy of institutions pushing forward sustainable investments will also promote the ongoing development of investment and financing.

The sustainable finance market in mainland China is growing all the time, despite the complex political and economic environment both domestically and internationally. By the end of the first quarter of 2023, the balance of green credit in mainland China exceeded 25 trillion yuan, and the balance of green bonds exceeded 1.5 trillion yuan – both are among the world's highest.[2] At the same time, the market for green insurance and green equity investment is also steadily expanding.[3]

The head of one mainstream financial institution stated that 'sustainable finance is both an opportunity and an unshrinkable mission for the financial industry'.[4] Such a view is echoed by many other market participants in sustainable finance.

Year in review

i Development and Changes

Development in regulatory regime

Establishment of National Carbon Peak and Carbon Neutralization Metering Technical Committee

The National Carbon Peak and Carbon Neutralization Metering Technical Committee was established in July 2023. Its responsibilities are to analyse and study metrology technologies in the areas of peak carbon and carbon neutralisation, make recommendations on major key issues, develop relevant technical specifications and align China's technical specifications of metrology with international standards.[5]

Introduction of ***the Green Insurance Classification Guidelines***

The Insurance Association of China (IAC), which is the national self-regulatory organisation for the insurance sector), issued The Green Insurance Classification Guidelines in September. The document was claimed to be the world's first industry self-discipline taxonomy that comprehensively specifies the classifications and key definitions with respect to green insurance products, green investment of insurance funds and green operations of insurance companies.[6]

Standardisation of ESG disclosure

In August, the State-owned Assets Supervision and Administration Commission (SASAC) circulated the guidelines and template for ESG reports by listed companies controlled by controlled state-owned enterprises.[7] This is the first time regulators in China have provided official detailed and systematic interpretation of ESG information disclosure requirements. See Section V for detailed discussion.

On 4 September 2023, the Beijing Private Equity Association issued Rules on Sustainable Investment Information Disclosure by Private Equity Fund Managers. This is the world's first set of sustainable investment and ESG industry group standards applicable to the private equity fund sector.[8] See Section V for detailed discussion.

Development of transition finance

With the steady growth of green finance, the regulatory authorities have started to pay attention to the development of transition finance (assisting firms to move towards net zero).[9] The PBOC has taken the lead in drafting the standards for transition finance in four high-carbon industries. Products with the theme of green transition and just transition have also been issued to echo the call.[10]

Development of carbon market

Proposed relaunch of CCER

After a six-year suspension, the registration and trading of voluntary emissions reductions under the China Certified Emission Reduction scheme (CCER) are expected to be relaunched within 2023. This is evidenced by the release of the Administrative Measures for Voluntary Greenhouse Gas Emission Reduction Trading (for Trial Implementation) – the updated measures on CCER (the CCER New Rules) by the MEE in October, as well as by other positive signals released by the regulators.[11]

First foreclosure of carbon assets

On 8 September 2023, a Sichuan local exchange foreclosed on some previously registered CCERs. This is the first time carbon assets became the subject of foreclosure in mainland China.[12]

Development of financial products

There has been a maturing market of financial products with a single green theme, and the market has begun to explore the combination of green and other themes. China's first dual-themed green and energy supply guarantee asset-backed securities (ABSs) and China's first green plus low-carbon transition themed-ABSs were issued in 2023. Environment-themed financial products have also begun to be more widely used, for example, in rural applications, and the first quad-themed CB with decarbonisation-related themes has been successfully issued. Also, green financial products have expanded from green industries to traditional industries: for example, the coal mining industry has issued its first carbon asset label bond, and the real estate sector has increasingly issued carbon-neutral commercial mortgage-backed securities (CMBSs) in the past few years.

Development in judicial sector

Apart from the first foreclosure of carbon assets mentioned above, China's first climate change action has also been settled. The settlement of the case provides a useful example of the resolution of this type of dispute.[13] See Section XI for more details.

ii Opportunities for China's sustainable financial markets

Opportunities for China's sustainable financial markets are mainly as follows.

Transition finance

As mentioned above, China's regulators and markets have begun to focus on transition finance. China's enormous traditional industrial base should offer huge potential to introduce transition finance.

Carbon markets

The relaunch of CCER will create opportunities for voluntary carbon trading and the development of applicable carbon financial products.

As for the carbon emission allowance market, although currently the only participants in the national carbon allowance market are power generation companies, many other participants will be permitted to join the market soon. In May 2023, the MEE initiated the Special Research on Expanding the Coverage of the National Carbon Market and stated at the kickoff meeting that the conditions for the expansion of the national carbon market are now in place. Currently, the inclusion of the steel, petrochemical and building materials industries currently are still under MEE's discussion. The Shanghai Environment Exchange has begun to prepare for the expansion of the National Carbon Market, with expectation that new industries will be included in 2024.[14]

Key industries for ESG-related investment

With the advance of the 30-60 decarbonisation goal (i.e., China's goal to peak its national carbon emissions by 2030 and to achieve carbon neutrality by 2060), new energy and low-carbon sectors will continue to be regarded as priorities for ESG investment.

As discussed above, the traditional high-carbon generating industries will gradually be included in the carbon market for trading via the National Carbon Market and involve the finance market in transition.

Regulation and policy

i Governance regime

Outlines of the key rules

The government of China ratified the Paris Agreement in 2016, and President Xi Jinping thereafter stated that China is striving to achieve the 30-60 decarbonisation goal. In 2022, the report of the 20th National Congress of the Communist Party of China (CCP) emphasised the need to adhere to sustainable development, to actively and steadily promote 'carbon peaking and carbon neutrality', to accelerate the green transformation of development methods and to actively participate in global governance addressing climate change. Green finance is regarded as one of the support measures for China's green development and transformation.[15]

Based on the 30-60 decarbonisation goal, China has established a '1+N' policy system, where '1' refers to the core of the system composed of two documents: CCP Central Committee and the State Council's Working Guidance for Carbon Dioxide Peaking and Carbon Neutrality in Full and Faithful Implementation of the New Development Philosophy, and 'N' refers to the implementation plans of numerous key areas and key industries and related support and guarantee plans.[16]

China's financial sector regulators first began to pay attention to environmental protection matters in the late 1990s with the proposal to explore the establishment of an environmental loan policy framework.[17] Since the issuance of the Green Credit Guidelines in January 2012, the CBIRC has successively issued a series of green credit rules and policies. In 2015, the CCP Central Committee and the State Council for the first time explicitly addressed the goal to build a 'green financial system' in the Overall Plan for the Reform of the Ecological Civilization System.[18] On 31 August 2016, seven ministries and commissions jointly issued the Guiding Opinions on Building a Green Financial System, which sought to establish sustainable finance at a macro level. Since May 2017, the PBOC has listed green finance standardisation as an important objective in China's 13th Five-Year Plan. In September 2018, under the guidance of the PBOC, the Green Finance Standards Working Group of the National Financial Standardization Technical Committee was formally established to establish a framework setting out sustainable finance standards. At the same time, the CBIRC, CSRC, NDRC and other governmental departments have issued a series of applicable policies and standards.[19]

With the proposal of the 30-60 decarbonisation goal and the establishment of the 1+N policy system, China is looking to upgrade and improve sustainable finance. Sustainable finance in China operates at many levels and in many manifestations, including green credit, green bonds, green stocks, green funds, green insurance and carbon emission trading markets.[20] The PBOC, SAMR, CBIRC, and CSRC issued the 14th Five-Year Plan for the Development of Financial Standardization in January 2022, which is expected to help further standardisation of China's sustainable finance sector.

Particularly noteworthy features of China's governance regime

With the 30-60 decarbonisation goal in progress, Chinese policymakers have been deliberately accelerating the development of regulations to promote the standardisation and improvement of the country's sustainable finance regime. For example, in April 2023, 11 government departments jointly announced a plan to formulate or renew no less than 1,000 national and industry standards by 2025, including green finance standards, carbon emission trading standards and ecological product value realisation standards.[21] The State Council has also been planning a high-level hierarchy and comprehensive Interim Measures on the Administration of Carbon Emissions Trading to address issues of lack of hierarchy and unified rules on carbon emissions trading.[22]

ii Regulators

China's regulations on sustainable finance are mainly led by the government, and supplemented by market and self-regulatory organisations. Government agencies involved including the NDRC, PBOC, former CBIRC (now NFRA), CSRC and MEE (and their branches or local counterparts), which, based on the top-level design of the ruling party and the State Council, will issue and implement specific regulatory rules and guidance for the relevant sector, either individually or jointly with other government departments. In addition to the government, stock exchanges and self-regulatory organisations of various financial sectors are also involved in the formulation and implementation of more detailed sustainable finance rules and guidance for the applicable financial sectors.

NDRC

Lead by the State Council, the NDRC mainly supports the development and high-level policy making of the green industry. In 2016, the NDRC, together with the PBOC, Ministry of Finance (MOF), CBIRC, CSRC and other authorities, issued the Guidelines for Establishing the Green Financial System. In 2019, the NDRC, together with other authorities, issued the Guiding Catalogue for the Green Industry (2019). In 2021, on the basis of the Guiding Catalogue for the Green Industry, the NDRC, PBOC, CSRC and other authorities jointly released the Catalogue of Projects Supported by Green Bonds (2021 Edition), which provides a specific list for the definition and standards of projects that could be supported by green bonds.

PBOC

The PBOC issued two financial industry standards, namely the Guidelines for Financial Institutions Environmental Information Disclosure (JR/T0227-2021) and Environmental Equity Financing Tool (JR/T 0228-2021). Together with the NDRC and the CSRC, it also issued the Catalogue of Projects Supported by Green Bonds (Edition 2021), a major taxonomy for China's sustainable finance. The PBOC also launched the Carbon-Reduction Supporting Tool and has been implementing the Special Refinancing for Clean and Efficient

Utilization of Coal, the two major sustainable finance incentives of China. See Section VII for more details.

CBIRC

Under the leadership and coordination of the PBOC, the CBIRC is mainly responsible for regulating green finance in the banking and insurance sectors. In 2012, the CBIRC issued the Guidelines for Green Credit. In June 2022, the CBIRC issued the Guidelines for Green Finance in Banking and Insurance Sectors, for the first time providing comprehensive and explicit guidance on the ESG-related obligations of financial institutions in China, and explicitly expanding the coverage of green finance guidelines from banks to insurance institutions. The CBIRC has also taken the lead in creating a number of supporting rules in relation to the above documents.

CSRC

The CSRC is mainly responsible for regulating green securities. For example, it issued the Guiding Opinions on Supporting the Development of Green Bonds in 2017. It also issued the Opinions on Accelerating the High-quality Development of the Public Fund Industry in 2022, pointing out that public funds should guide the industry to summarise the rules and principles of ESG investment, 'vigorously develop' green finance, actively practice responsible investment, improve the environmental performance of investment activities and serve the development of green economy.[23]

MEE, MOF, SAMR, and others

The MEE (formerly the Ministry of Environmental Protection, MEP), MOF, SAMR and others are primarily responsible for assisting the aforementioned regulatory authorities by jointly issuing rules and regulations. For example: (1) the PBOC, MOF, NDRC, former MEP, former CBRC, CSRC and the former China Insurance Regulatory Commission (CIRC) jointly issued the Guiding Opinions on the Building of a Green Financial System in 2016; (2) the PBOC, SAMR, CBRC and NDRC jointly issued the 14th Five-Year Plan for Financial Standardisation in 2022; and (3) the MEE formulated and implemented the Administrative Measures for the Mandatory Disclosure of Environmental Information by Enterprises.

In addition, the regulation of the relaunched CCER programme will be led by the MEE, with assistance from the SAMR.[24]

Exchanges

Domestic securities and futures exchanges will introduce specific rules or conduct pilot explorations in line with the government's green finance policy. Regional carbon exchanges will explore localised trading rules and policies for piloting purposes. See Section VIII for more details.

Self-regulatory organisations

Self-regulatory organisations of applicable sectors play an important role in the regulation of the sustainable finance. For example, the China Banking Association (CBA) issued the Guidelines on Corporate Social Responsibility of China's Banking Financial Institutions in 2009, and AMAC issued the Guidelines on Green Investment (for Trial Implementation) in 2018, which provided guidelines on sustainable finance. The Professional Committee on Green Credit established by the CBA implements self-regulation on green credit businesses; and the Professional Committee on Green Securities of the CSRC implements self-regulation on green securities. The IAC issued the Green Insurance Classification Guidelines, a taxonomy for green insurance products, green investment of insurance funds and green operations of insurance companies. See Section II for more detailed discussion.

Sustainable finance instruments

i Types of sustainable finance instruments

The following types of sustainable financing instruments are supported and active in China:

Green credit (green loans)

Green credit is the earliest green financial instrument adopted in mainland China. In 2007, the regulators stipulated policies on the duties imposed on green credit providers with respect to environmental protection, energy saving and emission reduction.[25] In 2012, the CBRC issued the Green Credit Guidelines, marking the beginning of the systematic development of green credit regulation and policy frameworks. In November 2021, the PBOC launched the Carbon-Reduction Supporting Tool, a refinancing project to support particular banks (now including foreign-funded banks) in developing their green credit business. See Section VII for details.

Green bonds

The green bond market in China started in 2015. The PBOC, NDRC and CSRC jointly issued the Catalogue of Projects Supported by Green Bonds (Edition 2021) in April 2021, which not only harmonised domestic standards but also aligned with mainstream international standards. It also served as an important basis for the Common Ground Taxonomy–Climate Change Mitigation (CGT) jointly published by the PBOC and the European Commission.

Green insurance

China's exploration of policies on environmental pollution liability insurance began in 2006.[26] In 2014, the NPC amended the Environmental Protection Law, Article 52 of which stipulated that the state encouraged taking up environmental pollution liability insurance, recognising environmental pollution liability insurance at the national legislative level for the first time.

In addition to voluntary pollution liability insurance, in 2013, the MEE and CIRC launched the pilot programme of compulsory environmental pollution liability insurance.[27] The requirement to establish a compulsory environmental pollution liability insurance regime in high-risk areas has been repeatedly mentioned in recent policies and is part of the 14th Five-Year Plan.[28]

In recent years, and the State Council called for 'vigorously developing' (i.e., paying extra attention to including) green insurance in a broader sense in the Action Plan for Carbon Dioxide Peaking before 2030.[29] To echo the regulator's call, IAC issued the Green Insurance Classification Guidelines in September 2023, specifying the classifications and key definitions with respect to green insurance products, green investment of insurance funds, and green operations of insurance companies. This document is expected to provide practical guidance for insurance companies to develop green insurance products and to promote their green transition.

Green investment products

Green investment products mainly refer to investment products linked to green rating, green stock index or ESG indicators.

The regulator have pointed out in principle to the need to develop green investment products.[30] In November 2018, the AMAC issued the Green Investment Guidelines (for Trial Implication) to provide further guidance on green investments.

Nowadays, green stock index exchange-traded funds (ETFs) and carbon neutral CMBSs are commonplace in China. Various investment products such as ABSs and real estate investment trusts (REITs) with the theme of greenness and transformation are also emerging.

Green funds

Green funds are investment funds established for the implementation of energy saving and emission reduction strategies, low-carbon economic development and environmental optimisation and renovation projects. At present, there are three categories of green funds in China, which are:

1. the National Green Development Fund, a government-operated fund jointly established in July 2020 by the MOF, MEE and Shanghai Municipal Government, aiming to guide private capital to invest in the green economy and green industries such as pollution treatment, ecological restoration, green transportation and clean energy;[31]
2. public–private partnership (PPP) funds. The government's attitude towards PPP funds once oscillated between cautious and positive.[32] Even so, at present, PPP funds have become an important way for local governments to provide green public goods and services;[33] and
3. purely market-oriented green funds funded by industrial firms or financial institutions.

Carbon emission rights and carbon financial products

See Section VIII.

Trading of other environmental rights and interests

The trading of other environmental rights and interests, such as pollution emission rights, energy use rights and water rights (ownership or use rights) are still at the stage of regional pilots. In March 2022, the State Council proposed the establishment of a unified national trading market for carbon emission rights and water use rights, and the promotion of market-oriented trading of pollution emission rights and energy use rights.[34]

In addition, some banks also offer green deposits (i.e., deposit programmes where funds are specifically used for the financing of green projects or green firms).

ii Focus of sustainable finance

Sustainable finance in China is not limited to the environment (E) sector. Sustainable financing in the society (S) sector has been carried out even earlier, mainly focusing on matters such as inclusive finance (including financing for small and micro enterprises and rural revitalisation), the Belt and Road Initiative (a global infrastructure development strategy adopted by the Chinese government in 2013 to invest in more than 150 countries and international organisations), assistance and relief for enterprises in difficulty and epidemic prevention and control.[35]

A study by the PBOC points out that currently in China agriculture and micro, small and medium-sized enterprises account for about 80 per cent of the total carbon emissions. The integration of inclusive finance and green finance and their full play in guiding and supporting green and low-carbon transformation across the agricultural areas and micro, small and medium-sized enterprises are inevitable requirements for achieving the 30-60 decarbonisation goal. Pilot green inclusive finance projects have been launched in Zhejiang, Shandong and other provinces to link financing with green transformation and ESG evaluation for micro, small and medium-sized enterprises and 'agriculture, rural areas and farmers'.[36] The first just transition loan was provided August 2023 by Postal Savings Bank of China, marking the beginning of the exploration of just transition finance by mainstream financial institutions.

iii Standardised documents to deliver climate, nature and biodiversity targets through financial instruments

While there has been some practical exploration, standardised documents regarding climate, nature and biodiversity targets for green financial instruments remain to be developed.

Sustainable disclosure requirements and taxonomy

Not all firms are required to disclose sustainability/ESG information. Firms obliged to make such disclosures are mainly listed companies. In addition, certain financial institutions carrying out green finance business and some firms of other businesses are also required to disclose certain relevant information.

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i Listed companies

The Guidelines on Governance of Listed Companies, as revised by the CSRC in 2018, establishes the basic framework for disclosure of ESG information by companies listed in China and sets out the principles that listed companies should disclose ESG-relevant information pursuant to laws and regulations and the requirements of the relevant authorities.[37]

The CSRC's current annual and interim report disclosure standards require listed companies to disclose administrative penalties imposed on them for environmental issues, while companies or their main subsidiaries that are key pollution dischargers identified by the MEE are required to disclose certain additional environmental information.[38] The above standards encourage (but do not oblige) listed companies to disclose relevant information about ecological protection, pollution prevention and control and performance of environmental responsibilities, as well as the verification/appraisal/evaluation by third-party institutions, and the carbon reduction measures and effects adopted by them.-[39]

The above standards also encourage (but do not oblige) listed companies to disclose the information relevant to the fulfilment of their social responsibilities in light of the characteristics of the business and industry they engage.[40] In addition, those standards also require certain disclosure of corporate governance information.[41]

At the level of exchange rules, sample companies in the 'SSE Corporate Governance Index' and 'SZSE 100 Index', companies listed on both domestic and offshore stock exchanges and listed financial institutions are required to prepare and disclose social responsibility reports separately from their regular annual reports.[42]

Listed companies engaged in industries with a large environmental impact are required by the SSE and SZSE to disclose certain information relating to pollution discharge and environmental protection as well as to highlight their environmental protection investment and environmental technology development; other listed companies are also encouraged to disclose such information of pollution discharge and environmental protection.[43]

Companies listed on the SSE STAR Market are required to disclose information of their fulfilment of social responsibilities in their annual reports, and to prepare and disclose separate social responsibility reports, sustainability reports, environmental responsibility reports and others 'if appropriate'; in addition, companies listed on the SSE STAR Market and the main boards of the SSE and SZSE are also required to disclose major accidents or negative impacts of improper fulfillment of social responsibilities in due course.[44]

In addition, listed companies engaged in specific industries may be required or encouraged to disclose certain specific ESR information by the SSE and SZSE.[45]

In addition to the above rules, the SASAC has further ESG promotion requirements for listed companies controlled by central state-owned enterprises. In the Work Plan for Improving the Quality of Listed Companies Controlled by Central State-Owned Enterprises released in May 2022, it is required that the headquarters of central enterprises shall advance the formation of ESG processes and operations of listed companies under their control, to improve the ESG performance, and 'play a leading and exemplary role in the capital market'; and it is also mentioned in the plan that the SASAC will require all listed companies controlled by central state-owned enterprises to begin disclosing ESG specific reports by the end of 2023.[46] The SASAC has promulgated disclosure guidelines (see below for the discussion on disclosure framework).

ii Financial institutions engaged in banking and insurance business

Financial institutions engaged in banking and insurance business are required by the CBIRC's Guidelines for Green Finance in Banking and Insurance Sectors to disclose 'in due course' their green finance strategies and policies, development of green finance and credit facilities and investments involving significant ESG risks; and when necessary, qualified and independent third parties may be engaged by such financial institutions to attest, assess or audit the fulfilment of these matters.[47] The CBIRC's Corporate Governance Guidelines for Banking and Insurance Institutions also require banking and insurance institutions to regularly disclose social responsibility reports to the public.[48]

iii Other firms

From February 2022, certain firms are required to disclose annual environmental reports by the MEE's Administrative Measures for the Mandatory Disclosure of Environmental Information by Enterprises, including: (1) key pollutant discharges; (2) firms subject to mandatory cleaner production inspection; (3) listed companies (including their consolidated subsidiaries) with certain environmental violations; and (4) bond issuers with identified environmental violations. The contents of such reports shall include information on the following matters:

1. environmental management, such as environmental licences/permits, environmental protection tax, environmental pollution liability insurance and environmental protection credit evaluation;
2. generation, treatment and discharge of pollutants;
3. carbon emissions, including emission amount and emission facilities;
4. response plans for environmental emergencies, heavy pollution weather or the like;
5. environmental violations;
6. disclosure of ad hoc environmental information according to the laws in the current year; and
7. other environmental information as prescribed by laws and regulations.[49]

The above-mentioned listed companies, bond issuers and firms subject to mandatory cleaner production inspection are also required to disclose certain additional information in their environmental annual reports.[50]

In addition to the environmental report, all the relevant firms mentioned above are required to disclose in a timely manner the information on: (1) obtaining and changes of status of environmental administrative licences/permits; (2) specific environmental violations; and (3) environmental damage compensation and the agreements related to them.[51]

The Chinese regulators have not officially adopted the Task Force on Climate-related Financial Disclosures (TCFD) framework, International Sustainability Standards Board (ISSB) sustainability and climate disclosure standards or the like, and neither have they formulated any holistic or unified disclosure regime. However, some regulators and industry groups have issued relevant non-compulsory disclosure frameworks of their own accord as follows.

In July 2021, the PBOC issued the Guidelines for Financial Institutions Environmental Information Disclosure, which provide guidance for financial institutions (such as banks, asset managers, insurance companies, trusts, futures companies, and securities companies) to follow when disclosing environmental information, in terms of the principles, formalities and specific contents of disclosure.[52]

In April 2022, the China Enterprise Reform and Development Society (CERDS) released the Corporate ESG Disclosure Guidelines (T/CERDS 2-2022) Group Standard, the first ESG information disclosure standard in China. The guidelines set out a total of 118 indicators in the three ESG aspects (environment, society and governance) for firms of different industries and different development stages to choose from in their ESG disclosures.[53]

On 4 September 2023, the Beijing Private Equity Association (BPEA) issued the General Principles for Disclosure of Sustainable Investment Information for Private Investment Fund Managers (T/BPEABPEA 001-2023) Group Standard, which claimed to be the world's first group standard for sustainable investment/ESG in the private investment fund sector.[54]

In August 2023, the State-Owned Assets Supervision and Administration Commission (SASAC) circulated the Indicative Indicator Systems for ESG Specific Reports of Listed Companies Controlled by Central State-Owned Enterprises and the Indicative Template for ESG Special Reports of Listed Companies Controlled by Central State-Owned Enterprises among certain state-owned enterprises at the central and local levels, which provide a starting point for the preparation of ESG reports by listed companies controlled by state-owned enterprises. The SASAC stressed that the ESG indicators selected in these guidelines are in line with international common standards, such as GRI, TCFD, SDGs and ISO, and are 'conceptually consistent with the new ISSB standards', taking into account local factors.[55] However, currently only certain selected stated-owned enterprises have access to these documents.

The major relevant taxonomies with respect to sustainable finance are:

1. Guiding Catalogue of Green Industries: A taxonomy jointly published by multiple regulatory authorities, including the NDRC, Ministry of Industry and Information Technology, Ministry of Natural Resources, MEE, Ministry of Housing and Urban-Rural Development, PBOC and National Energy Administration, which sets

up the scope of green industries as commonly recognised by regulatory authorities of various sectors and aids in formulating applicable policies, including sustainable finance policies, across different sectors;

2. the Catalogue of Projects Supported by Green Bonds: Issued by the PBOC, NDRC and CSRC, the catalogue specifies the definition and standards of projects supported by green bonds. It was amended in 2021 to align with European standards, laying the groundwork for the launch of the CGT;
3. Common Ground Taxonomy-Climate Change Mitigation (CGT): As a technical document for voluntary reference by interested parties, the CGT is based on the activities currently included in both the adopted EU taxonomy for sustainable activities and the Catalogue of Projects Supported by Green Bonds of China.[56] The current version of the CGT covers six major fields: (1) agriculture, forestry and fishery; (2) manufacturing; (3) electricity and heat supply; (4) water resources and solid waste treatment; (5) construction; and (6) transportation and storage; and
4. the Green Insurance Classification Guidelines: An industry self-discipline taxonomy issued by IAC that comprehensively specifies the classifications and key definitions with respect to green insurance products, green investment of insurance funds and green operations of insurance companies.

ESG data, ratings and reporting

Like most other jurisdictions, the biggest challenge in China's ESG data report regime is the lack of clear and widely recognised standards. The maturity, rationality and market acceptance of the guidelines issued by the PBOC, CERDS, BPEA and SASAC are yet to be tested. In addition, there is no mandatory requirement in China that ESG/sustainability reports should be audited by third-party institutions. Therefore, firms may prefer not to disclose negative information, making it difficult for investors to know their actual ESG practices.[57]

China's primary sustainable benchmark is the 30-60 decarbonisation goal. Specific transformation benchmarks and plans are developed at the local level or in specific industry sectors based on this goal.

China has yet to introduce rules regulating ESG data and rating providers.

Although the CBIRC once stipulated the relevant transformation requirements in its released Guidelines for Green Finance in Banking and Insurance Sectors, these requirements are more hortatory than mandatory, there is no definitive, mandatory phase-in plan for the ESG transformation for most of the financial institutions. However, various financial institutions have been urged to fulfil ESG obligations. For example:

1. banks and insurance companies are required by former CBIRC to attach importance to their own ESG performance and establish applicable processes and systems;[58]
2. securities companies are required by the CSRC to actively disclose their work in fulfilling their social responsibilities, as well as measures for other social welfare undertakings.[59] They may also be subject to the CSRC's specific evaluation of on these aspects, which will affect the ratings and categories;[60] and

3. public funds are required by the CSRC to actively practice social responsibility and develop green finance.[61]

Sustainable finance incentives

China's sustainable finance incentives mainly include the following two monetary policy tools:

China's sustainable finance incentives mainly include the following two monetary policy tools:

i Carbon-Reduction Supporting Tool

A refinancing project launched by the PBOC in November 2021, whose mechanism is that the PBOC provides refinance loans at 60 per cent of the principals of qualified carbon emission reduction loans granted by certain financial institutions (currently including national banks, local legal person financial institutions and foreign financial institutions) to relevant firms in key sectors of carbon emission reduction (such as clean energy, energy conservation and environmental protection and carbon emission reduction technology), with an annual interest rate of 1.75 per cent and a term of one year that can be extended twice. Those supported financial institutions are required to publicly disclose information concerning the issuance of carbon emission reduction loans and the amount of carbon reductions as a result of the loans, with such information verified by third-party professional agencies.[62]

As at 3 March 2023, the PBOC has provided refinance loans of over 300 billion yuan through the Carbon-Reduction Supporting Tool, supporting commercial banks in issuing carbon emission reduction loans of over 500 billion yuan, and driving reduction of 100 million tons of carbon dioxide in 2022.[63] The PBOC has announced that it will continue to implement the Carbon-Reduction Supporting Tool until the end of 2024.[64]

ii Special refinancing for clean and efficient utilisation of coal

A 200 billion yuan refinancing project was set up by the State Council on 17 November 2021 to promote the green and low-carbon transformation of the coal energy industry. The PBOC provides refinancing loans equal to the principals of qualified loans for this purpose granted by certain national banks.[65]

The PBOC has announced that it will support the grant of special refinancing for clean and efficient use of coal until the end of 2023.[66]

In addition, the MEE and other regulators launched the pilot programme for climate finance at the end of 2021, marking the beginning of China's exploration of climate finance.[67] In August 2022, the MEE announced a list of 23 climate finance pilot sites. These pilot sites will aim to address climate change and, based on their own characteristics, curb investments into local high-carbon emitters and, instead, guide funds to be invested in climate-friendly projects, develop carbon finance, enhance carbon accounting and information disclosure, innovate business model and financial instruments, strengthen supporting policy and build a national climate finance project bank.[68]

The MEE also expressed its intent to further strengthen its work on climate finance, including building a platform to match funds to projects, strengthening information disclosure, encouraging innovative financial instruments and services, supporting the participation of financial institutions and enterprises and developing international cooperation.[69]

With respect to transition finance, at the end of 2022, China took the lead in the launch of the G20 Transition Finance Framework, which guides G20 members to formulate specific policies for transition finance compatible with their own circumstances. While the international consensus on the framework of transition finance is broadly in place, China began to frame its own transition finance regulations: for example, the National Association of Financial Market Institutional Investors and the Shanghai Stock Exchange have released standards and specifications concerning 'transition finance bonds'; several financial institutions have released their guidelines on transition finance bonds and on innovative products of transition finance; and Huzhou City, Zhejiang Province has issued China's first local supportive policies and catalogues.[70] With respect to transition of specific industries, the PBOC has led the draft of transition finance standards for four industries: coal power, iron and steel, building materials and agriculture, which will be released for public comments in due course.[71]

See Sections I, III, V and VI for other aspects of the market that affect sustainable finance.

Carbon markets and carbon trading

i Layout of Carbon Markets

Mandatory carbon market

The mandatory carbon market (i.e., carbon emission allowance market) in China comprises trading at the National Carbon Market and at several regional carbon exchanges.

In 2011, the NDRC issued the Notice on Carrying Out the Pilot Programs for Carbon Emission Permit Trading, marking the commencement of the pilot phase of regional carbon trading markets. Several regional carbon exchanges started trading around in 2013 and 2014, and, up to now, nine regional carbon exchanges in total have been established in China.[72] For pilot purposes, industry coverage, trading rules and operational mechanisms vary from exchange to exchange. As well as regional carbon emission allowances, CCERs are also traded in these regional carbon exchanges. In addition, piloting and innovative carbon finance products and trading models have also been experimented with at some regional carbon exchanges.

In 2020, the MEE issued the Measures for the Administration of Carbon Emissions Trading (for trial implementation), followed by its three complementary rules issued in May 2021.-[73] Thereafter, the National Carbon Market was launched on 6 July 2021, after which no new regional carbon exchanges was planned to be established. All existing regional carbon exchanges will be gradually integrated into the National Carbon Market so as to achieve the goal of establishing a unified carbon market in the jurisdiction. Although only the power generation industry is currently permitted to participate in trading in the National Carbon Market, regulators have been discussing and considering expanding the coverage to other industries, such as petrochemicals, chemicals, architectural material, iron and steel, non-ferrous metals, paper-making and aviation.

Voluntary carbon market

The voluntary carbon market (i.e., voluntary carbon emission reduction trading market), in China comprises: (1) trading of CCERs in a national market (which has been suspended) and regional carbon markets; and (2) trading of local versions of certified emission reduction (CER) instruments in the relevant regional carbon markets. For the national trading market of CCER, with the release of the CCER New Rules and other positive signals, we expect a relaunch some time in 2023. For more details, see Section II.

ii Maturity of carbon markets

China's policymakers share the viewpoint that China's carbon markets have solid basis and great potential. They divide the market into two parts: (1) a direct trading market of carbon emission rights (i.e., carbon emission allowance and voluntary carbon emission reduction); and (2) a market for carbon finance products and relevant derivative instruments.

The direct trading market of carbon emission rights in China, compared with most leading offshore carbon markets, still has some gaps in a number of ways, including the industry scope coverage, tradeable greenhouse gases emission rights and the total value of the market.

With respect to carbon finance, despite the sporadic developments of carbon finance products in certain pilot areas or by certain financial institutions, the development of carbon finance in China is still essentially in a pilot phase, lacking a systematised and comprehensive market and product system and balanced development among different regions. The framework of carbon finance products operation is based on the National Standard of Carbon Finance Products issued by the CSRC in April 2022, according to which carbon finance products are divided into three categories: (1) carbon trading instruments (e.g., carbon forwards, carbon futures, carbon options, carbon swaps and carbon lending); (2) carbon financing instruments (e.g., carbon bonds, carbon assets pledge, carbon assets repurchase and carbon assets custody); and (3) carbon supporting instruments (e.g., carbon index, carbon insurance and carbon funds).

iii Major challenges

Inadequate regulatory frameworks

The rules for National Carbon Market are governed by relatively low-level regulatory authorities, and most of the rules are either interim or for trial implementation. In addition, more specific regulations, statistical systems and disclosure requirements for domestic carbon markets need to be further promulgated or improved. The inconsistency in the trading rules, carbon emission calculation methods and carbon accounting standards among the National Carbon Market and the regional carbon exchanges may also cause consistency and accuracy issues for carbon information disclosure.

Relative underdevelopment of carbon finance products

China's carbon finance products and derivatives are still at an early stage of development, and carbon finance products trading is yet not incorporated into the National Carbon Market. Though some regional markets have introduced carbon-related financial products, market participation is limited and the development is uneven among different regions. In addition, the legal nature of carbon assets is yet to be clarified, hampering the development of carbon finance products and deterring market participation.

Limited participation and coverage of the nationwide carbon market

See discussions above.

Concerns on accounting accuracy of carbon emissions

Following the release of the Notice on the Supervision and Management of Data Quality in the National Carbon Emissions Trading Market in October 2021, in March 2022, the MEE published typical cases of falsification of carbon emission data to warn of inaccurate accounting of carbon emissions.[74] In light of this, in April 2022, the NDRC, National Bureau of Statistics and MEE jointly issued the Implementation Plan on Accelerating the Establishment of a Unified and Standardized Carbon Emissions Statistics and Accounting System. And in December 2022, the MEE issued the Guidelines for Accounting and Reporting of Greenhouse Gas Emissions by Enterprises (Power Generation Facilities) to further address the management of accounting accuracy in relation to carbon emissions.

Difficulties in integrating regional carbon exchanges into the National Carbon Market

Given the differences between the regional carbon exchanges and the National Carbon Market and among the regional carbon exchanges themselves, as well as the significant value of regional exchanges to meet the needs of regional trading and serve as pilots for new policies and products, the integration of regional carbon markets into the National Carbon Market will be an extremely complex issue.

Limited connection with international carbon markets

There is currently no direct connection for carbon allowance swap trading between China and offshore carbon emissions trading markets. Foreign investors can open accounts for carbon allowance trading in a few regional carbon exchanges, but they cannot participate in trading on the National Carbon Market. At present, the CCER New Rules only permit entities registered in China to participate in the registration and trading of CCERs.[75]

The Greater Bay Area (GBA) has been planning a bridge between domestic and international carbon markets. In March 2022, the Guangzhou Carbon Exchange and the Hong Kong Exchange announced that they would jointly explore the possibility of creating a voluntary emission reduction system applicable to the GBA. On October 2022, the Hong Kong Exchange announced the launch of Core Climate, a new international carbon market platform for internationally certified carbon credit products. The platform is dedicated to connecting the international capital markets with climate-related products and opportunities in Hong Kong, mainland China, and the rest of the world. Guangzhou also announced in 2022 its intent to launch a foreign exchange pilot permitting qualified foreign investors to trade carbon emissions in the GBA, following the previous pilot launched in 2014 by Shenzhen. There is also a proposal to build a new carbon market trading system in the GBA, to be called Carbon Connect, to open up cross-border carbon trading channels and allow global investors to participate in China's carbon market.[76]

Outside the GBA, Hainan Province is also exploring cross-border voluntary carbon trading to serve the Belt and Road Initiative. In December 2022, the first cross-border carbon transaction was successfully concluded on the Hainan Carbon Centre, with the underlying product being an international voluntary carbon emission reduction.[77]

Green technology

In China, the interaction between technology and sustainable finance is mainly reflected in the following three aspects.

First, when policymakers introduce policies to encourage and support new industries, they often take sustainable finance supporting measures, emphasising the cooperation between green technology R&D entities and financial market participants.[78] For example, industries such as new energy vehicles (NEVs) and photovoltaic/wind energy/hydrogen energy are both hot spots for scientific and technological development and for investment in financial markets. The support from sustainable finance is even more necessary for R&D and innovation in costly green technologies, such as CCUS (i.e., carbon capture, utilisation and storage). Banks have begun providing loans for CCUS projects with the PBOC's Carbon-Reduction Supporting Tool (see Section VII).[79]

Second, green technology is helping to generate related financial products. For example, the development of NEVs has prompted insurance companies to develop power battery liability insurance, charging facility liability insurance and other related products.[80]

Third, digital technology is empowering the development of sustainable finance. For example:

1. some local governments have built green financial service platforms based on data technology to interconnect sustainable finance, ESG information and financing providers to guide and support the sustainable development of firms;[81]
2. some banks have launched green credit management systems utilising big data and AI technologies to improve the quality and efficiency of the granting of green loans;[82]
3. some insurance companies use satellite remote sensing technology in forestry carbon sink insurance to detect the accumulation, growth and loss of forestry carbon sink;[83] and
4.

some funds have been utilising digital technologies such as AI, machine learning and natural language processing to develop localised ESG scoring systems to evaluate their investment targets.[84]

Climate change, nature and biodiversity impacts

As early as 2009, China's legislature proposed including climate change into the legislative agenda. Based on the 30-60 decarbonisation goal, China now established a comprehensive '1+N' policy framework, as detailed in Section III. However, up to now there are still no holistic and specialised laws or regulations on climate change in China.[85]

China has achieved positive results in addressing climate change in recent years. In 2020, China's carbon emission intensity achieved a decrease of 48.4 per cent compared with 2005, exceeding China's target of 40 to 45 per cent. In 2020, the proportion of coal used in total energy consumption was 56.8 per cent, down from 72.4 per cent in 2005, while the proportion of non-fossil energy in total energy consumption reached 15.9 per cent. From 2011 to 2020, China's energy intensity decreased by 28.7 per cent.[86]

China has become the world's largest producer and seller of NEVs and has formed the world's most comprehensive industrial chain for the manufacturing of wind power and photovoltaic power generation equipment.[87]

In terms of ecology, since the adoption of the 14th Five-Year Plan (i.e., in 2021), China's forest coverage rate has reached 24 per cent, and its forest stock has reached 19.5 billion cubic metres, making it the country with the fastest growth of forest resources in the world.-[88]

Greenwashing and climate litigation risks

No specific rules on greenwashing have been issued in China, but the current regulatory regime is able to deal with greenwashing to a large extent. As the essence of greenwashing is false market promotion and publicity or false information statements, depending on the specific circumstances, it can be covered by laws regulating commercial marketing (such as competition laws, advertising laws, consumer protection laws and product quality laws), the information disclosure requirements in Securities Law and listing rules or even, in grave situations, the crime of illegal disclosure or failure to disclose important information under the criminal law.

Greenwashing conducted by a financial institution may also constitute a violation of regulations applicable to that specific type of financial institution. For example, if a publicly offered fund purporting to make green or sustainable investment fails to strictly fulfil these commitments, it may be found to have violated regulations concerning deviation of investment direction, investment scope, investment strategy or investment ratio stipulated in its investment contract.[89] The violation may be subject to 'rectification' (i.e., revision and remediation) orders and warnings from the CSRC.

From a green finance perspective, the conduct of greenwashing is largely due to the lack of unified standards for the evaluation and identification of sustainable finance, which leads to the abuse of the concepts of 'green' and 'sustainable'. The regulators have been aware of the need to formulate a system standard for sustainable green finance. At the central level, in February 2022, the PBOC, SAMR, CBIRC and CSRC jointly issued the 14th Five-Year Plan for the Development of Financial Standardization, requiring improvements to green finance standards.[90] In March 2022, the CCP Central Committee and the State Council issued the Opinions on Accelerating the Construction of a Unified National Market, pointing out the need to 'cultivate and develop a unified national environmental asset market', 'implement unified and standardised industry standards and transaction supervision mechanisms' and 'promote the formation of green product certification and labelling systems'.[91] Local regulators have also been actively exploring the standardisation of sustainable finance.[92]

In 2016, the Supreme People's Court (SPC), the highest court of China, noted the matter of climate change and required the judicial system to 'actively explore proper judicial responses to climate change, in contribution to the construction of a national climate change response governance system', and to review cases related to carbon emissions, energy transition, green finance and biodiversity conservation.[93] The number of air pollution-related cases heard by courts in China has increased significantly since 2016, from dozens or hundreds per year to over 12,000 in 2019, but has declined rapidly since 2020 and had fallen to about 2,500 by the end of 2022.[94]

The SPC has added 'carbon emissions trading disputes' and 'carbon sink trading disputes' as causes of action for civil disputes, and local courts have gradually begun to hear such cases.[95]

In terms of climate change-specific actions, there have been only been two lawsuits brought in China. Both actions were brought by Friends of Nature, a non-profit organisation, against the local subsidiaries of State Grid in 2016 in Gansu Province and in 2018 in Ningxia Hui Autonomous Region, respectively, where Friends of Nature claimed that by abandoning wind and photovoltaic power generation in the relevant region in favour of fossil fuels, State Grid would worsen climate change.[96] The lawsuit in Gansu Province was mediated in April 2023, with State Grid undertaking to invest an additional 913 million yuan in the construction of grids transferring power generated by new energies, and to disclose information on the development of wind and photovoltaic power generation in a timely manner.[97] The case in Ningxia is still ongoing.

Outlook and conclusions

Standardisation will be the theme of sustainable finance regulation in China in the near future. It is expected that sustainable guidelines for more at present non-covered financial sectors may be issued gradually, on the basis of experience accumulated in existing fields such as banking, insurance and green bonds.

Laws and regulations passed by a higher hierarchy may also be introduced to match the progress of the 30-60 decarbonisation goal and to respond to market expectations for more unified and predictable rules.

Transition finance will be a hot spot, thanks to China's huge scale of traditional industry, agriculture, and micro-, small and medium-sized firms. Transition finance standards for more industries or firms are expected to be introduced, along with the emerging of more transition-themed financial transactions and products.

For ESG, with the disclosure standards for listed companies controlled by national government-owned enterprises and PE industries testing the water, governmental regulators and industry organisations may begin to draft more comprehensive and unified ESG disclosure guidelines or standards, to address the call of the market for more truthful, unified and transparent ESG disclosure.

The carbon market is expected to become more active. With the National Carbon Market now in operation for two years, we can expect more industries to be permitted to join trading, significantly increasing the market size of carbon allowance trading.

New CCER trading rules was released this year, paving the way for the long-expected relaunch of CCER registration and trading, which will inject more vitality and opportunities into the voluntary carbon trading market. Hopefully, the integration of national and local carbon markets, accompanied by unified trading and product rules, will also bring more predictability, convenience and confidence to the product designs and carbon finance transactions.

Internationalisation is also a trend. With the release of first batch of domestic green bonds conforming to the CGT, the enhanced alignment between the domestic and international market will bring more incentive and confidence to cross-border investors to invest in the sustainable bond market in China. We can also expect more exploration in cross-border carbon trading at some point, including a trading platform open to cross-border investors and carbon emission rights, as contemplated by Guangzhou regulators in the GBA.

Endnotes

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ENDNOTES

Introduction

The sustainable finance framework for the Hong Kong market is voluntary. While there are no specific regulatory or legal requirements for sustainable finance, several financial regulators in Hong Kong, such as the Hong Kong Monetary Authority (HKMA), the Securities and Futures Commission (SFC) and The Stock Exchange of Hong Kong Limited (HKEX), have been spearheading support for sustainable finance and have continued to issue guidance on related topics such as ESG disclosure requirements and climate-related risk management.

At the regional level, in February 2023, the Asia Pacific Loan Market Association (APLMA), jointly with the Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA), issued updates to the principles and guidance on three types of sustainable loans: green loans,[2] sustainability-linked loans (SLLs)[3] and social loans.[4] The updates provide the latest industry standards for sustainable lending within the Asia Pacific region.

Despite a challenging macroeconomic environment with interest rate volatility, investors' demand for sustainable finance products remains robust. In the Asia-Pacific region excluding Japan, green and sustainability-related bond issuances totalled US$83.2 billion as at 16 June 2023, compared with US$137.3 billion for the whole of the past year.[5] This can be credited to the support and interest from key stakeholders including companies, financial institutions, regulators and the Hong Kong government.

Hong Kong aims to develop into a green financial hub in the region. In line with this ambition, the Hong Kong government has taken a lead role in sustainable finance with the issuance of green bonds through the Government Green Bond Programme. See Section II for details. Further, various regulators have published strategic frameworks and created working groups to encourage the development of a sustainable finance ecosystem in Hong Kong. The relevant frameworks and initiatives are described below.

Hong Kong companies have been involved in sizable sustainable finance deals as well. In June 2022, a Hong Kong property developer signed the largest SLL in the real estate sector in Hong Kong for HK$20.7 billion.[6] Further, well-known Hong Kong companies and public entities recognise the importance of sustainable finance and have developed sustainable finance frameworks. The framework for sustainability reporting and disclosure standards is described in Section V.

Financial institutions continue to encourage the development of sustainable finance. For example, HSBC boosted the size of its Greater Bay Sustainability Fund to US$9 million from its initial outlay in May 2022 of US$5 billion to fund projects within the Greater Bay Area region that aim to reduce carbon emissions.[7]

With the active involvement of key players in the sustainable finance market, the Hong Kong green finance market has encouraged mainland Chinese firms to access offshore sustainable financing. The HKEX remained the largest venue for China's offshore green bond listings in 2022, taking up 43 per cent of the offshore volume from mainland China-domiciled issuers.[8]

The above summary reflects the prevailing positive attitude in the market towards sustainable finance, which has continued from the previous year.

Year in review

Despite the challenging market environment, the Hong Kong sustainable finance market remained strong and continues to grow. In June 2023, the Hong Kong government announced the successful triple-currency offering of the largest ESG bond issuance in Asia. The offering was close to US$6 billion and is denominated in US dollars, the euro and the yuan,[9] breaking the previous record of a US$5.75 billion multicurrency deal in January 2023.[10]

To promote the application of innovative technology in the green finance space, in February 2023, the Hong Kong government launched its inaugural tokenised green bond programme with an issuance of up to HK$800 million, which was the first of its kind by a government globally.[11] The tokenisation of bonds is based on blockchain technology, which removes intermediaries and streamlines the otherwise lengthy process of bond issuance.[12]

Hong Kong aspires to contribute to the global green transition. In May 2023, the Hong Kong Mortgage Corporation (HKMC) issued Hong Kong's pilot infrastructure loan-backed securities worth around US$400 million, with a sustainability tranche of US$100 million.[13] The securities cover 25 projects in the Asia-Pacific, the Middle East and South America.[14] See Section IV.

In addition to an increase in social-based sustainable products in 2023, ocean-based sustainable finance products have emerged as a new product class. This is expanded upon in Section IV.

At the same time, concerns about greenwashing remain although there has not been any significant legal or regulatory action on this front. See Section X for more details.

To increase the measurability of sustainable projects, the HKMA published plans for a green taxonomy to be prepared for the local market. Further, Hong Kong regulators, including the Cross-Agency Steering Group, have voiced support for the inaugural International Sustainability Standards Board (ISSB) sustainability disclosure standards finalised in June 2023, namely IFRS S1 (General Requirements for Disclosure of Sustainability-related Financial Information) and IFRS S2 (Climate-related Disclosures) (collectively, the IFRS Sustainability Disclosure Standards). HKEX intends to align the disclosure standards for listed companies with these standards, taking into account local circumstances. See Section V for more details on disclosure standards.

Regulation and policy

i Governance regime

The People's Republic of China (PRC) ratified the Paris Agreement in 2016 and, in accordance with the Basic Law of Hong Kong, declared that the Paris Agreement applies to Hong Kong. In September 2020, President Xi Jinping stated that China will aim for peak carbon emissions prior to 2030 and carbon neutrality prior to 2060, which is otherwise known as the '30.60' decarbonisation goal.[15] Hong Kong has a role to help fulfil the PRC's obligations under the Paris Agreement. Hong Kong aims to reduce total carbon emissions by 50 per cent before 2035 using 2005 level as a base, and to reach carbon neutrality prior to 2050.

The government's commitment is demonstrated by its plan to deploy HK$240 billion over the next 15 to 20 years (from 2021) to combat climate change.[16] The acceleration of sustainable finance and the development of Hong Kong into a green financial hub in the region form part of the strategies and opportunities identified in the government's Climate Action Plan 2050.

Green and Sustainable Finance Cross-Agency Steering Group

In May 2020, Hong Kong established the Green and Sustainable Finance Cross-Agency Steering Group (the Cross-Agency Steering Group), a multi-regulatory steering group co-led by the HKMA and the SFC. Other members are the Environment Bureau, the Financial Services and the Treasury Bureau (FSTB), HKEX, the Insurance Authority and the Mandatory Provident Fund Schemes Authority (MPFA). The Cross-Agency Steering Group aims to coordinate the management of climate and environmental risks to the financial sector, accelerate the growth of green and sustainable finance in Hong Kong and support the government's climate strategies.

The Cross-Agency Steering Group has launched a number of initiatives including the Centre for Green and Sustainable Finance (the GSF Centre), a cross-sector platform designed to coordinate the efforts of financial regulators, government agencies, industry stakeholders and academia in capacity building and policy development. It serves as a repository for resources, data and analytics and supports the development of a sustainable finance ecosystem, such as with its GSF Data Source Repository. In June 2022, the Cross-Agency Steering Group worked with the Hong Kong government to pilot the Green and Sustainable Capacity Building Support Scheme (the GSCBS Scheme), which aims to subsidise training for and the acquisition of relevant professional qualifications by existing and prospective practitioners. The GSCBS Scheme was successfully launched in December 2022[17] and as at early July 2023, 38 reimbursement applications have been approved, involving a total reimbursement amount of over HK$220,000.[18]

In August 2023, the Cross-Agency Steering Group announced its priorities to further strengthen Hong Kong's sustainable finance ecosystem which include: (1) developing a comprehensive Hong Kong roadmap on adopting the IFRS Sustainability Disclosure Standards as appropriate to the Hong Kong market; (2) capacity building (in particular for small and medium-sized enterprises (SMEs)), data enhancement and technology innovation; and (3) growing the market with diverse products to mobilise capital.[19]

ii Regulators

The main regulators involved in regulating, enforcing and promoting sustainable finance frameworks in Hong Kong are the SFC, HKMA, HKEX and the MPFA. The guidelines and papers issued by these regulators are not directly applicable to sustainable finance, but form part of the regulatory ecosystem that financial institutions operate in.

SFC

The SFC is an independent statutory body charged with regulating the securities and futures markets in Hong Kong.

In 2018, the SFC published the Strategic Framework for Green Finance. The SFC listed five main focus areas, namely:

1. improving HKEX-listed companies' climate-related disclosure obligations;
2. engaging with relevant stakeholders to formulate disclosure obligations for the asset management industry;
3. facilitating the development of a wider range of green investment products;
4. supporting investor awareness of and capacity building in green finance and investment-related matters; and
5. promoting Hong Kong as an international green finance centre by participating in international green initiatives.[20]

The Fund Manager Code of Conduct (FMCC) was amended, with effect from August 2022, to introduce climate-related disclosures. This is discussed in Section V.

HKMA

The HKMA is Hong Kong's central banking institution, which is the governmental authority responsible for maintaining monetary and banking stability in Hong Kong.

In June 2020, the HKMA published a white paper on green and sustainable banking,[21] which outlines the HKMA's supervisory approach to climate-related issues for the banking sector. The HKMA issued a set of climate change risk management guidelines for banks in December 2021. See Section IX for details.

HKEX

The HKEX is the stock exchange based in Hong Kong. In December 2020, the HKEX launched the Sustainable and Green Exchange (STAGE). It provides access to a comprehensive database of sustainable and green investment options available in Hong Kong's securities markets as well as a sustainable finance education and advocacy platform.

To promote transparency and disclosure, the HKEX's listing rules include ESG reporting requirements which will be updated to take into account the latest requirements set out in the IFRS Sustainability Disclosure Standards.[22] See Section V for details.

MPFA

The MPFA is in charge of supervising the provision of Mandatory Provident Fund (MPF) retirement schemes. In November 2021, the MPFA introduced Principles for Adopting Sustainable Investing in Investment and Risk Management Processes of MPF Funds (MPFA Principles).[23] The MPFA Principles outline a high-level integration of ESG considerations for trustees of the MPF, a compulsory retirement savings scheme for Hong

Kong residents. While ESG investing within the MPF system is a relatively new concept, interest is growing with 120 per cent asset growth over the past five years to 30 June 2023.[24] The government also plans to earmark a certain proportion of future issuances of government green bonds for priority investment by MPF funds.[25]

Hong Kong Quality Assurance Agency

Although not a regulator, the Hong Kong Quality Assurance Agency (HKQAA) is a key player in promoting green and sustainable finance in Hong Kong.

The HKQAA is a non-profit public organisation established by the government in 1989 to introduce international management standards and promote good management practices and sustainability in the Greater China region. One of its most significant contributions is the Green and Sustainable Finance Certification Scheme (the Certification Scheme), where the HKQAA provides third-party compliance assessments for sustainable requirements of finance instruments. On 6 September 2023 at the Forum on Conformity Assessment Serving Trade Facilitation in China, HKQAA's Certification Scheme was selected by China's State Administration for Market Regulation as an 'excellent' example of 'Special and Sophisticated' International Collaboration on Mutual Recognition of Quality Certification.-[26]

Sustainable finance instruments

Green bonds and sustainability-linked and green loans are the most popular types of sustainable finance debt instruments. Climate Bonds[27] has noted that in 2022, despite the overall challenging global environment, over US$27 billion of green, social, sustainability, transition and sustainability-linked (GSS+) bonds, were arranged in Hong Kong, capturing more than one-third of the Asian green and sustainable bond market.[28] GSS+ loans totalling over US$52 billion were issued in Hong Kong in 2022, which was more than double the amount in 2021.[29]

Apart from the above debt instruments, sustainable deposits and green retail certificates of deposit have also been introduced by large banking institutions into the market.[30]

In May 2023, the HKMC issued Hong Kong's first infrastructure loan-backed securities under its pilot scheme on infrastructure financing securitisation through a special purpose vehicle, Bauhinia ILBS 1 Limited (Bauhinia 1). Within the capital structure of Bauhinia 1, there is a US$100 million sustainability tranche backed by sustainable, green and social assets.[31]

Social-based sustainable finance continues to gain traction in Hong Kong. In September 2023, the HKMC issued its second social bond of close to HK$20 billion equivalent, which marked the largest social bond issuance in Asia and was the first time for a Hong Kong bond issuer to launch HK dollar, yuan and US dollar tranches in one transaction. The net proceeds from the issuance will mainly be used to finance or refinance the Special 100% Loan Guarantee under the SME Financing Guarantee Scheme, which was launched in April 2020 to alleviate cash flow pressure of SMEs in Hong Kong during the covid-19 pandemic. It has benefited more than 35,000 local SMEs and 362,000 related employees up to December 2022.[32] Further, Mayer Brown acted for a syndicate of banks including Sumitomo Mitsui Banking Corporation (as social loan adviser) in a HK$2 billion and

US$241 million social loan facility with China Gas Capital Management Limited (a wholly owned subsidiary of China Gas Holdings Limited, a leading natural gas operator in China) as the borrower, which is the first syndicated social loan in the Greater China region.[33]

Apart from social-based debt instruments, a new type of sustainable finance investment product that focuses on ocean-friendly projects known as blue finance has emerged in the Asia-Pacific region. Blue finance, including blue bonds are growing in importance among investors and policymakers due to the region's dependence on coastal and marine resources.[34] Since Asia's first blue bond issuance by the Bank of China in September 2020, there have been landmark blue bond issuances in the region by a relatively diverse set of issuers.[35] Turning to government-led issuances, the People's Government of Hainan Province and the Shenzhen Municipal People's Government separately issued offshore yuan-denominated local government blue bonds in Hong Kong in November 2022.[36]

Sustainable disclosure requirements and taxonomy

A mix of mandatory and comply-or-explain disclosure requirements exists in Hong Kong for listed companies and financial institutions as summarised below. There are no sustainability-related disclosure requirements that apply to SMEs. However, in December 2022, the Cross-Agency Steering Group collaborated with the CDP (formerly known as the Carbon Disclosure Project), a not-for-profit charity, to launch an SME Questionnaire to help SMEs begin their sustainability reporting journeys.[37]

Listed companies

The HKEX's ESG reporting guide (within the listing rules) contains two types of disclosure obligations for listed companies on the Main Board and on the Growth Enterprise Market. First, there are mandatory board governance disclosure requirements, such as disclosure of the board's oversight of ESG issues. Second, the comply-or-explain requirements concern key performance indicators across 12 areas of environmental and social issues ranging from emissions to supply chain management.[38]

In addition, Paragraph 28(2)(d) of Appendix 16 of the Main Board Listing Rules requires the listed company's directors' report for a financial year to contain a business review as prescribed in Schedule 5 of the Companies Ordinance (Cap. 622). The business review must include, among other things, a discussion on the company's environmental policies and performance to the extent necessary for an understanding of the development, performance or position of the company's business.

The HKEX issued a consultation paper in April 2023 that proposed enhancing the climate-related disclosures required for listed companies to align with the IFRS Sustainability Disclosure Standards, which were in draft form at the time the consultation paper was published. Notably, the proposed amendments upgrade climate-related disclosures from the current 'comply or explain' approach to mandatory disclosures. Recognising the difficulties that issuers may face, certain proportionate measures and time-limited transition reliefs have been proposed in the HKEX's proposals. For example, a two-year interim period has been proposed for the disclosure of quantitative financial effects of climate-related risks and Scope 3 carbon emissions data.[39] The HKEX's new requirements were initially expected to apply to ESG reports for financial years commencing on or after 1 January 2024. However, the HKEX subsequently announced that the implementation date will be postponed by a year to 1 January 2025 to enable the HKEX to take into account the ISSB's adoption guide for the finalised IFRS Sustainability Disclosure Standards, which is expected to be available before the end of 2023, and to allow more time for issuers to familiarise themselves with the new requirements.[40] The results of the HKEX's consultation paper were pending at the time of writing.

Financial institutions

The SFC's FMCC was amended in 2022 to require fund managers of collective investment schemes to take climate-related risks into consideration in their investment and risk management processes and make the appropriate disclosures. At a minimum, annual disclosures should be made regarding climate-related governance, risk management and investment management.[41] Large fund managers[42] must make efforts to collect and disclose Scope 1 and Scope 2 greenhouse gas emissions data, whereas smaller fund managers are not required to comply with this requirement.

The HKMA's Supervisory Policy Manual GS-1 on Climate Risk Management requires financial institutions to incorporate climate risk considerations into their strategic frameworks and make climate-related disclosures aligned with the TCFD recommendations.[43]

With regard to investment products, the SFC issued guidance on 29 June 2021 on the disclosure standards of ESG funds through a circular to management companies of SFC-authorised unit trusts and mutual funds involving ESG factors. It requires a fund's offering documents to provide information necessary for investors to make an informed judgment about the investment, including the fund's ESG focus, ESG investment strategy, expected proportion of ESG investment (in terms of net asset value), any reference benchmark and related risks.[44] The guidelines require ESG fund managers to conduct periodic assessments of the attainment of their ESG focus and to disclose the results through effective means such as annual reports.

The MPFA Principles require MPF trustees to disclose ESG integration strategies and report implementation progress regularly and disclose metrics, describe how ESG factors are factored into the relevant investment strategies and disclose metrics and targets adopted by investment managers where possible.

The regulators in Hong Kong are committed to align sustainability-related disclosure in Hong Kong with the TCFD recommendations by 2025. Following the finalisation of the IFRS Sustainability Disclosure Standards, the Cross-Agency Steering Group announced its plans to develop a 'comprehensive Hong Kong roadmap' to adopt the standards, taking into account local regulatory expectations and circumstances. A working group will be set up with participation from relevant authorities and stakeholders, to make recommendations on the elements to be covered by the roadmap.

Hong Kong taxonomy

Work is underway to prepare a green taxonomy for the Hong Kong market. In May 2023, the HKMA released a discussion paper titled 'Prototype of a Green Classification Framework for Hong Kong'. The Green Classification Framework is a taxonomy developed by the

Cross-Agency Steering Group that will be interoperable with other taxonomies, such as the Common Ground Taxonomy and the taxonomies of the European Union and mainland China. Three 'layers' of depth provide green definitions of different degrees of precision, taking into account the complexity of the activities and applicability in the Hong Kong context. The proposed Green Classification Framework will be developed in phases. The current phase aims to develop the taxonomy for four initial sectors, namely:

1. electricity, gas, steam and air conditioning supply;
2. transportation and storage;
3. water supply, sewerage, waste management and remediation activities; and
4. construction.[45]

ESG data, ratings and reporting

See Section V for a discussion on reporting requirements.

There are two main challenges in the ESG data reporting regime.

First, there are challenges surrounding data availability. At present, reporting is only required for a narrow range of entities such as financial institutions, listed companies and companies that issue ESG funds. Many SMEs would not have the financial means or access to the technology to disclose ESG data, which affect the availability of the sector's data to financial institutions and investors. The SME Questionnaire developed by the Cross-Agency Steering Group and the CDP, as referenced above, helps to address this issue.

Second, even where data is available, it may not be sufficiently granular to fully evaluate a particular ESG metric. HKEX has previously emphasised that there is no one-size-fits-all approach for ESG reporting frameworks.[46] While this is true, difficulties may also arise regarding which reporting standard to adopt and the breadth and depth of the reporting done by each company, which can lead to difficulties when comparing the disclosed data between industries and markets. The recent finalisation of the IFRS Sustainability Disclosure Standards and the strong support it has received globally may help to mitigate this problem going forward.

ESG ratings and data products providers are currently not regulated in Hong Kong. However, there are plans to introduce a voluntary code of conduct for ESG service providers providing products and services in Hong Kong. In October 2023, the SFC issued a report entitled 'Report on the fact-finding exercises on ESG ratings and data products providers', which sets out the SFC's conclusions following a fact-finding exercise to understand the business models of ESG service providers and the market practice of licensed asset managers in Hong Kong who engage with such service providers. The report noted the SFC's intention to promote the recommendations of the International Organization of Securities Commissions (IOSCO) concerning ESG service providers,[47] to address issues on data quality, transparency and conflicts of interest management. Taking a pragmatic approach, the SFC announced it would sponsor and support an industry-led working group to develop a voluntary code of conduct (VCoC) for ESG service providers providing products and services in Hong Kong, which includes a self-attestation document for ESG service providers. The International Capital Market Association will serve as the secretariat for the working group and leverage on its relevant experience to promote interoperability of the VCoC among different jurisdictions. Further, the SFC intends to issue guidance to licensed corporations on using the VCoC for due diligence and assessment of ESG service providers.

Sustainable finance incentives

One of the most notable incentives that the government has implemented is the Green and Sustainable Finance Grant Scheme (the GSFG Scheme), which supports issuers in Hong Kong in accessing sustainable financing.[48] The GSFG Scheme consists of two tracks. Track I covers general bond issuance costs (such as arrangement, legal, audit and listing fees) for eligible first-time green and sustainable bond issuers. Track II covers external review costs (such as pre-issuance external review, post-issuance external review and reporting) for eligible green and sustainable bond issuers and loan borrowers.[49] As at the end of May 2023, close to HK$180 million has been granted under the GSFG Scheme to about 250 green and sustainable debt instruments issued in Hong Kong, involving a total underlying debt issuance of over HK$600 billion.[50]

In addition, the government has set out four decarbonisation strategies in the Climate Action Plan. These involve net-zero electricity generation, energy saving and green buildings, green transport and waste reduction.[51] Public and private companies embarking on such projects are likely to require sustainable financing.

To assist the banking industry in its net-zero transition journey, in August 2023, the HKMA issued a circular detailing some high-level principles on planning for the transition to carbon neutrality for the banking industry. Banks prioritising carbon neutrality will further encourage a healthy, sustainable finance ecosystem.

Given Hong Kong's reputation as an international finance centre and the important roles that the HKMA, SFC, HKEX and MPFA have played in upholding this status, their individual transition frameworks and guidelines to transform Hong Kong into a sustainable economy will serve as important benchmarks for companies seeking to remain compliant and competitive, and develop and maintain a good reputation in the market.

Carbon markets and carbon trading

On 28 October 2022, the HKEX launched Core Climate, an international carbon marketplace for the trading of voluntary carbon credits and instruments. The Core Climate platform enables parties to source, hold, trade, settle and retire voluntary carbon credits. Projects listed on the platform will be verified against international standards such as the Verified Carbon Standard. As at early October 2023, the number of participants in Core Climate has tripled to nearly 70 since its launch.[52]

Despite the growth and increase in the number of participants in Core Climate, the Hong Kong carbon market is still at a development stage and faces significant challenges. In the primary market where project developers create and sell carbon credits to buyers, there are issues concerning high upfront registration costs and a long registration and approval process for carbon credits. In the secondary markets, the lack of transparency on standards may lead to the double counting of carbon credits, undermining the integrity of the market.-[53] At the same time, due to the highly fragmented market, there is a lack of liquidity and supply of high-quality carbon credits in the secondary markets.[54]

Green technology

Hong Kong's start-up community is actively involved in the development of green technology as one of the Hong Kong Science Park's five core technology clusters. The government has provided funding to support environmental technology-related research and development (R&D) projects under the Innovation and Technology Fund (ITF). As of July 2023, the ITF has approved over 240 environmental technology-related projects, with the total funding exceeding HK$575 million.[55]

In addition, in 2020, the government established the Green Tech Fund (GTF), totalling HK$400 million, to support R&D projects that can help Hong Kong decarbonise and enhance environmental protection. As of June 2023, the GTF has approved 22 projects from local universities, designated research institutes and private enterprises, involving a total funding of about HK$100 million.[56]

Climate change, nature and biodiversity impacts

Hong Kong's initiatives have yielded positive results in its aim to reach carbon neutrality before 2050. Preliminary data shows that Hong Kong's green house gas emissions in 2022 were lower than those in 2021 and on a par with total emissions in 2020.[57] However, climate change is increasingly evident in our living and working environments. Accordingly, a more cohesive and global approach is required to effectively combat climate change.

In December 2021, the HKMA published the results of a climate risk stress test (CRST) on banks. The test indicated that the Hong Kong banking sector should remain resilient to climate-related shocks given the banks' strong capital buffers. However, the use of simplified assumptions and historical data could mean that the potential impact may be more serious than predicted.[58] In April 2023, the HKMA issued guidelines for a second round of CRST,[59] which enhanced the 2021 CRST by providing a broader set of scenario variables and assumptions to support more granular assessments of the banks' exposures to climate risks. To reduce the reporting burden on the banks, the second round of CRST will be undertaken over an extended period from June 2023 to June 2024.[60]

In response to the risks identified from the 2021 CRST, the HKMA published the Supervisory Policy Manual GS-1 (see Section V),[61] and issued a circular in June 2022 to lay out its two-year plan to integrate climate risk management into its supervisory processes and agenda.[62] Given the increasing focus on banks' integration of climate risk management, in August 2023, the HKMA issued a circular setting out some high-level principles to assist banks in planning for a net-zero transition.[63]

Aside from the banking industry, in June 2023, the Green Building Council launched Hong Kong's first 'Climate Change Framework for Built Environment' (Framework for Built Environment) to facilitate Hong Kong building sector's transition to carbon neutrality. The Framework for Built Environment assists the building industry in setting net zero carbon goals, reporting ESG achievements, justifying green finance requirements and disclosing climate risk strategies.[64]

Greenwashing and climate litigation risks

Given the dramatic growth of sustainable finance in the local market, greenwashing is a growing concern. In December 2022, the HKMA issued a circular on due diligence processes for green and sustainable products where it identified good practices to implement to reduce greenwashing risks.[65] In addition, the HKMA released a research report in November 2022, entitled 'Greenwashing in the Corporate Green Bond Markets',-[66] which noted that about one-third of global corporate green bond issuers may be reaping the benefits of issuing green bonds without cutting down their greenhouse gas emissions.

New legislation is not required for greenwashing claims to be commenced in Hong Kong. Existing causes of action under common law – such as the tort of misrepresentation, and statutory causes of action pursuant to legislation, such as the Trade Descriptions Ordinance (Cap. 362) and the Securities and Futures Ordinance (Cap. 571) – can form the basis of a greenwashing claim. However, restrictions around representative actions and the prohibition against contingency fees means the likelihood of these claims are likely to be lower in the Hong Kong courts as compared to other jurisdictions, such as the United States. Nonetheless, reputational risks will remain a material consideration for companies.

Hong Kong has a history of environmental public interest litigation, including environmental cases with mixed success.[67] It is not uncommon for Hong Kong courts to hear judicial review cases brought by parties who seek to challenge the Town Planning Board's planning permissions on environmental grounds.[68]

Since mandatory climate-related regulations are new and relatively limited, there has not been any noteworthy climate-related litigation or enforcement action in Hong Kong. Nonetheless, regulatory checks on compliance with the new ESG disclosure and reporting requirements are expected and may lead to the first such enforcement action in the coming years. In addition, the global trend of increased shareholder and NGO activism as a result of greenwashing concerns is likely to apply in Hong Kong as well.

Outlook and conclusions

In the 2023–2024 Budget Speech, the Financial Secretary of Hong Kong outlined the initiative of developing Hong Kong into an international centre for green technology and finance.

The Hong Kong government aspires to issue no less than HK$15 billion retail green bonds in the next financial year and will also consider policy initiatives to promote wider use of tokenisation technology in Hong Kong's capital markets.[69]

The government's ambitious goals signify Hong Kong's commitment to a low-carbon economy, which could lead to lower cost of capital for the sustainable finance market. This is likely to stimulate increased funding of sustainable projects in the region and anchor Hong Kong as an attractive location for PRC companies to issue offshore sustainable debt.

Ongoing regulatory developments will further enhance Hong Kong's ESG ecosystem. The roll out of the Green Classification Framework (i.e., a common taxonomy to classify and label financial products) and the completion of the VCoC for ESG service providers will help to reduce greenwashing risks, improve investor confidence and attract international capital. Likewise, the HKEX's introduction of mandatory climate-related disclosure requirements for listed companies would increase the availability of ESG data for investors.

At the same time, significant market challenges remain.

First, there is a lack of harmonised sustainability definitions and classification systems in the market, which may affect the credibility of sustainable finance products. Even though work is underway to prepare the Green Classification Framework for Hong Kong, it is uncertain when this will be finalised and rolled out to the local market. Additional phases of the Green Classification Framework will also need to be developed to cover more sectors. Market participants would also need time and guidance to accustom themselves to the new taxonomy for it to be used effectively.

A second key challenge is the shortage of talent to meet demand in the sustainable finance market in Hong Kong. To address this issue, the government seeks to attract ESG professionals from abroad and build capacity locally. Experienced professionals in ESG have been added to the Talent List of Hong Kong, which lists the professions that are most needed in the immediate to medium term for Hong Kong's economic growth. These professionals are entitled to receive preferential residency treatment.

Overall, despite the current challenging macroeconomic landscape, we believe that Hong Kong's sustainable finance ecosystem will grow and go from strength to strength over the coming years. The steady increase of sustainable finance locally within Hong Kong and regionally within the Greater Bay Area and the PRC, the increasing global demand for sustainable finance products and Hong Kong's commitment to fulfil its climate goals by 2050 collectively reflect Hong Kong's potential as an international sustainable finance hub.

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Introduction

At the United Nations Climate Change Conference (UNCCC) in Glasgow in November 2021 (COP26), India committed to achieve net zero emissions by 2070. Following the COP26, India updated its nationally determined contributions (NDCs). It is estimated that to achieve its NDCs, India requires capital flow of approximately US$170 billion per year in clean energy, clean transport and energy efficiency.[2]

The Indian regulatory framework for sustainable finance is at an early stage of development. The existing framework is primarily focused on sustainable finance for energy, but work is underway on disclosure standards and other aspects, and Indian regulators have introduced rules and guidelines on incorporation of environmental, social and governance (ESG) standards in the operation of corporate entities and certain other specific aspects of sustainable financing, including mandatory guidelines for ESG rating providers and issuance of green deposits.

Year in review

There is an increased focus by the government and Indian regulatory authorities on ESG matters generally, and on sustainable finance in particular.

In the past year, the Indian regulatory framework on sustainable finance has considered the transition of the Indian economy to net zero emissions, but this is at a nascent stage.

Following India's presidency at the G20, the government has introduced various programmes to encourage sustainable finance and has prioritised green growth and inclusive development in the budget for 2023–2024.

The government issued sovereign green bonds (SGBs)[3] for mobilising resources towards green infrastructure projects, in accordance with a green bonds framework.[4] The government also launched a green credits programme to promote voluntary environmental actions of various stakeholders (the Green Credits Programme),[5] and a carbon credit trading scheme (CCTS)[6] has been notified.

The Securities and Exchange Board of India (SEBI), the Indian securities regulator, issued circulars:

1. permitting the establishment of a separate sub-category of mutual fund schemes for ESG investments (SEBI ESG circular);[7]
2. on Business Responsibility and Sustainability Report (BRSR) and BRSR Core, identifying additional key performance indicators (KPIs) across various ESG attributes (the SEBI BRSR circular);[8]
3. to revise the regulatory framework for green debt securities (the SEBI GDS circular);[9]
4. laying down guidelines to prevent greenwashing (the SEBI Greenwashing circular);-[10] and
5. on regulation of ESG ratings providers (ERPs) (the SEBI ERPs circular).[11]

The Reserve Bank of India (RBI), the Indian central bank, released a framework for acceptance of green deposits by financial institutions (the Green Deposits Framework).[12] RBI also released a research report setting out the range of policy options available to mitigate climate risks (the RBI research report).[13]

The International Financial Services Centres Authority (IFSCA), the regulator for International Financial Services Centres (IFSC) in India,[14] signed a memorandum of understanding with Climate Policy Initiative for cooperation to increase mobilisation of global sustainable capital flows into India.[15]

Regulation and policy

i Governance regime

In order to achieve India's targets of carbon neutrality and net zero emissions by the year 2070,[16] the following key laws and policies have been formulated on certain aspects of sustainable finance.

Key laws and regulations in relation to sustainable finance

(Indian) Companies Act, 2013

The Ministry of Corporate Affairs (MCA), which monitors and administers all companies and limited liability partnerships incorporated in India, introduced the concept of corporate social responsibility (CSR) in the (Indian) Companies Act, 2013 (CA2013). The CA2013 requires that companies with a certain specified net worth must constitute a CSR committee and formulate a CSR policy, and ensure that they spend at least 2 per cent of their average net profits made during the three immediately preceding financial years on CSR activities as per their CSR policy.[17]

SEBI regulations

SEBI has mandated that the top 1,000 equity listed entities by market capitalisation must issue a BRSR report, which must include disclosure of ESG-related information, aimed at helping market participants assess sustainability-related risks and opportunities;[18-] and certain granular and quantifiable metrics seeking disclosures[19] on listed entities' performance, against the nine principles of the National Guidelines on Responsible Business Conduct (as published by MCA).[20] SEBI has recently enhanced the BRSR reporting through the introduction of BRSR Core where certain new KPIs have been identified for assurance and reporting.

SEBI has also prescribed additional disclosures in offer documents for issuance of green debt securities (GDS)[21] and published guidelines for issuers of GDS to prevent greenwashing.[22]

SEBI has permitted mutual funds to establish a separate subcategory of mutual fund schemes for ESG investments (ESG schemes) under equity mutual fund schemes and prescribed the investment criteria and disclosure requirements for ESG schemes.[23] A regulatory framework for the regulations of ERPs has also been notified by SEBI.[24]

SEBI is also reviewing[25] its framework for social stock exchanges (SSEs) to provide not-for-profit organisations and social enterprises an alternate platform to raise funds from institutional and retail investors.[26]

RBI regulations

In 2007, RBI issued a note[27] aimed at creating awareness among banks about their role in relation to CSR, sustainable development and non-financial reporting. RBI also mandates financial institutions to allocate a certain percentage of their adjusted net bank credit to certain priority sectors, including social infrastructure and renewable energy.[28]

RBI has also issued a framework[29] for the acceptance of green deposits by financial institutions that mandates allocation of proceeds from green deposits to the specified green activities.

Other regulations

IFSCA has notified regulations on issuance and listing of ESG debt securities, including green bonds, social bonds, sustainable bonds and sustainability-linked bonds with the intent of attracting international capital towards sustainable sectors.[30] These regulations require the appointment of an independent external reviewer, and also prescribe specific additional disclosures in offer documents and post-listing continuous disclosures concerning utilisation of proceeds. IFSCA has also set out a framework[31] on sustainable and sustainability-linked lending by financial institutions operating in IFSC.

Recent government policies

In 2023, the government issued a framework[32] to regulate the issuance of SGBs. An additional allocation of 350 billion rupees for priority capital investments towards energy transition and India's NDCs has also been announced.[33]

The government has also launched various incentives for the implementation of major renewable energy programmes in India.[34]

Partnerships with international organisations

India is a member of the International Platform on Sustainable Finance,[35] which has encouraged India to introduce laws to increase accountability in the area of sustainable finance.

The Green Growth Equity Fund, a joint India–United Kingdom fund,[36] has also been established and aims to make equity investments in green infrastructure projects in India.

Pursuant to the EU–India Connectivity Partnership,[37] the European Investment Bank (EIB) and the State Bank of India have agreed to back an initiative of €100 million for new high-impact climate action and sustainability business financing.[38] EIB had also invested in the construction of metro lines in some Indian cities for green and affordable transport.[39] In 2021, the Asian Infrastructure Investment Bank approved the Chennai City Partnership: Sustainable Urban Services Programme aimed at improving the quality and financial sustainability of selected urban services in Chennai.[40]

Public and private institutions in India

The government has established organisations such as the Indian Renewable Energy Development Agency Limited (IREDA),[41] Rural Electrification Corporation (REC)[42] and National Bank for Agricultural and Rural Development (NABARD)[43] for providing finance for the renewable energy sector and promoting sustainable and equitable agriculture. The Small Industries Development Bank of India (SIDBI) has introduced various financing instruments to support investments for environmentally and socially positive purposes.[44]

Other private financial institutions also offer financial services in relation to renewable energy in India.

Many public and private organisations in India offer concessional rates of lending if certain specified sustainability criteria are established. This lending is generally enabled through bilateral lines of concessional credit from international agencies and funds.[45]

A number of large financial institutions in India follow the International Finance Corporation's Environmental and Social Performance Standards and certain global sustainability reporting frameworks like the Global Reporting Initiative and the CDP reporting framework.[46] However, the RBI survey[47] conducted on climate risk and sustainable finance policies of several commercial banks in India notes that climate and sustainability risks and opportunities are still not being discussed at the board level of most financial institutions, and that a majority of the surveyed banks have not yet quantified their portfolio regarding climate-related risks.

Alternative avenues, such as the National Clean Energy and Environment Fund[48] and the National Adaptation Fund for Climate Change[49] to fund innovative projects in clean energy technologies and build climate change resilience, respectively, have also been set up by the government.

ii Regulators

RBI

In order to learn from and contribute to environmentally sustainable development, RBI has joined the Central Banks and Supervisors Network for Greening the Financial System (NGFS).[50] RBI has also set up a sustainable finance group (SFG) to lead regulatory initiatives in climate risk and sustainable finance.[51] RBI expects that the SFG will play a key role in evolving a regulatory framework, including appropriate disclosures, which could be prescribed for banks and other regulated entities over sustainable practices and mitigation of climate-related risks in India.[52]

From a social perspective, RBI has notified regulations and guidelines to deepen financial inclusion in India (including the setting up of small finance banks and payments banks),[53] to enable sustainable development[54] by improving the quality of lives of the marginalised sections of Indian society.

SEBI

SEBI has introduced guidelines for issuance and listing of GDS in India, as well as disclosure requirements such as ESG disclosures in the form of, inter alia, BRSR and BRSR Core reporting.

MCA

MCA has published the National Guidelines on Responsible Business Conduct (NGRBC)-[55] to meet its commitment to the United Nations Guiding Principles on Business and Human Rights and align with the United Nations sustainable development goals (SDGs). Recognising the significance of non-financial reporting, along with the formulation of the NGRBC, MCA has also constituted a committee on business responsibility reporting (the BRR Committee) to frame business responsibility reporting formats that, inter alia, reflect SDGs for both listed and unlisted companies.[56]

IFSCA

As discussed in Section III.i, IFSCA has notified regulations on the issuance and listing of ESG debt securities and a framework on sustainable and sustainability linked lending by financial institutions operating in IFSC.

Other key government agencies

IREDA

The government established IREDA under the administrative control of the Ministry of New and Renewable Energy (MNRE). IREDA is engaged in promoting, developing and extending financial assistance for setting up projects concerning new and renewable sources of energy, energy efficiency and conservation.[57] IREDA receives its funding from multilateral agencies (in many cases with guarantees by the government) and provides a range of financial products from project conceptualisation to post-commissioning in the renewable energy sector.[58]

SIDBI

SIDBI is an accredited agency of the Green Climate Fund, a fund established within the United Nations Framework Convention on Climate Change,[59] and promotes sustainable development through a series of schemes that seek to provide adequate and affordable energy efficiency and green finance among small and medium-sized enterprises.[60] SIDBI has launched a number of schemes to promote sustainable finance (such as the green finance scheme and the end-to-end efficiency scheme) and provides financial support to energy service companies.[61]

Sustainable finance instruments

i Types of sustainable finance instruments

Indian regulations as well as voluntary guidelines primarily deal with environment-focused sustainable finance instruments. Over the past year, the government has actively focused on making the regulations consistent with international standards (such as the International Capital Market Association's Green Bond Principles (the ICMA Principles))[62] and has introduced instruments focused on transitioning to sustainable operations. Certain regulatory measures such as the PSL and ESG schemes and the establishment of SSEs (as discussed in detail below) consider social- and governance-focused sustainable financing. The Indian legal framework on sustainable finance instruments is constantly evolving, and standardised drafting or implementation has not yet been developed given the recent introduction of sustainable instruments.[63]

Sustainable financing through equity

Indian laws do not regulate any specific aspect of sustainable financing through equity instruments. However, the general framework on equity investments applies to sustainable financing by way of equity as well. Foreign investors or persons resident outside India are also permitted to invest in up to 100 per cent equity of Indian companies operating in the renewable energy sector, without any prior government approval.

Sustainable financing through debt

The following instruments for sustainable financing, through debt, have been specifically prescribed in the Indian legal framework:

Green debt securities (GDS)

Issuance and listing of GDS is governed by SEBI through the SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 (the NCS Regulations),[64] and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.[65] The NCS Regulations define a green debt security as a debt security issued for raising funds that are to be utilised for projects or assets, or both, falling under any of the following categories, subject to the conditions as may be specified by SEBI from time to time:

1. renewable and sustainable energy including wind, solar, bioenergy and other sources of energy that use clean technology;
2. clean transportation including mass and public transportation;
3. climate change adaptation, including efforts to make infrastructure more resilient to impacts of climate change and information support systems such as climate observation and early warning systems;
4. energy efficiency, including efficient and green buildings;
5. sustainable waste management, including recycling, waste to energy and efficient disposal of wastage;

6. sustainable land use, including sustainable forestry and agriculture, and afforestation;
7. biodiversity conservation;
8. pollution prevention and control (including reduction of air emissions, greenhouse gas control, soil remediation, waste prevention, waste reduction, waste recycling and energy efficient or emission efficient waste to energy) and certain specified sectors;
9. circular economy adapted products, production technologies and processes (such as the design and introduction of reusable, recyclable and refurbished materials, components and products, circular tools and services) and eco-efficient products;
10. blue bonds comprising funds raised for sustainable water management, including clean water and water recycling, and the sustainable maritime sector, including sustainable shipping, sustainable fishing, fully traceable sustainable seafood, ocean energy and ocean mapping;
11. yellow bonds, comprising funds raised for solar energy generation and the upstream industries and downstream industries associated with it;
12. transition bonds comprising funds raised for transitioning to a more sustainable form of operations, in line with India's NDCs; and
13. any other category as may be specified by SEBI.

Sovereign green bonds

The government has issued a framework for the issuance of SGBs, which mandates that proceeds of SGBs be utilised towards projects that encourage energy efficiency in resource utilisation, reduce carbon emissions and greenhouse gases, promote climate resilience or adaptation and value and improve natural ecosystems and biodiversity.

ii Hybrid sustainable financing

Green deposits

The Green Deposits Framework regulates the issue of interest-bearing deposits received by a financial institution, the proceeds of which are earmarked for allocation towards green finance. Under this framework, a list of green activities to which the proceeds of the green deposits may be allocated has been identified, including renewable energy, energy efficiency, clean transportation, climate change adaptation, sustainable water and waste management.

This framework requires the appointment of an independent external reviewer to verify the utilisation of funds and publishing of an impact assessment report, which shall be mandatory from 2024–2025.

At present, GDS, SGBs and green deposits are the only expressly recognised and regulated instruments for sustainable financing in the Indian domestic market (excluding IFSCs).

iii Other sustainable financing mechanisms

Priority sector lending

RBI has issued priority sector lending (PSL) guidelines[66] to channel lending to corporates for the achievement of SDGs and to foster social and inclusive development. Under the PSL guidelines, RBI has identified eight priority sectors, which include renewable energy, education, housing and social infrastructure. RBI mandates targets of lending in each priority sector for different categories of banks in India.

ESG schemes

The SEBI ESG circular regulates the ESG schemes.[67] ESG schemes should be launched with a specified strategy, such as impact investing, sustainable objectives and transition or transition-related investments. In order to encourage sustainable disclosures, ESG schemes must invest 65 per cent of their assets under management in companies that are complying with BRSR and BRSR Core. SEBI has also mandated mutual funds to disclose the BRSR and BRSR Core scores of the invested securities, the name of the ERPs providing these scores and to obtain an independent reasonable assurance regarding the ESG scheme's portfolio being in compliance with the strategy and objective.

Sustainable finance instruments recognised in IFSC

IFSCA regulations permit the issuance of green, social, sustainable or sustainability-linked debt securities. Such debt securities are defined as those securities that are intended to be utilised for financing projects aligned with the international frameworks, such as the International Capital Market Association Principles and Guidelines, the Climate Bonds Standard, ASEAN Standards, European Union Standards and Taxonomy, any framework or methodology specified by a competent authority in India or other international standards, as considered on a case-by-case basis by recognised stock exchanges or IFSCA (IFSCA Recognised Frameworks).[68]

IFSCA also permits sustainable and sustainability linked lending by financial institutions operating in the IFSC[69] and has mandated that financial institutions should have at least 5 per cent of their gross outstanding loans and advances disbursed during the previous year towards green, social, sustainable and sustainability-linked sectors.[70]

Impact bonds

There have been a few issuances of social impact bonds and development impact bonds in India.[71] However, there is no specific legal framework that regulates the issuance of these bonds.

iv Other sustainable finance instruments

Other than the regulated instruments discussed above, there are various types of sustainable finance instruments voluntarily offered by financial institutions in India, such as sustainability-linked loans (where the interest rate on the loan is linked to the achievement of certain sustainability goals by the borrower)[72] and loans for specific green products such as solar panels, electric vehicles and charging infrastructure.[73]

The National Voluntary Guidelines for Responsible Financing, released by the Indian Banks' Association, set out eight principles through which ESG factors should be integrated into business operations of banks.[74] These principles encourage financial institutions to collaborate with government, investors and development finance institutions and offer diverse instruments to mobilise capital for green projects.[75]

v Other aspects of the financial system

To make fundraising for green projects attractive, the India International Exchange entered into a memorandum of understanding with the Luxembourg Stock Exchange to provide issuers the opportunity of dual listing.[76] Further, an international sustainability platform was also launched at GIFT-IFSC, India's first IFSC.[77] The major Indian stock exchanges have set up benchmark indices that assess the carbon performance of stocks[78] and ESG risk score[79] based on certain quantitative parameters.

Further, SEBI has introduced a framework for operation of SSEs in India to enable not-for-profit organisations and social enterprises to raise capital (by way of equity, debt or units).

India does not at present have any specific sustainable finance framework for green securitisation, derivatives and aftermarket trading.

Sustainable disclosure requirements and taxonomy

i MCA

MCA constituted the BRR Committee that recommended two reporting frameworks. The first is a comprehensive business responsibility and sustainability report consisting of three sections: general disclosures, management and process and principle-wise performance. The second reporting framework is a 'lite' version of a former format for smaller companies looking to start non-financial reporting.[80] MCA has proposed that these formats will be used to develop a Business Responsibility–Sustainability Index, which will enable organisations, including the central and state governments, to give preference in their procurement processes to businesses that demonstrate responsible business conduct. MCA has also released the National Guidelines on Responsible Business Conduct.[81]

The CA2013 also prescribes certain disclosure requirements to be fulfilled by listed and unlisted companies, such as mandatory disclosures concerning CSR actions undertaken by them.[82] Further, companies are required to include a report by their board of directors on conservation of energy, along with their annual financial statement.[83]

ii SEBI

In 2021, SEBI revised the ESG reporting structure in BRSR with the intent of collecting quantitative and standardised information on ESG parameters for comparative functionality of the data.[84] BRSR has been made mandatory for the top 1,000 equity listed companies based on market capitalisation from 2022–2023. SEBI has recently enhanced the BRSR report through the introduction of BRSR Core where certain new KPIs such as job creation in small towns, openness of business and gross wages paid to women have been identified for assurance and reporting. The reasonable assurance requirement of the BRSR Core shall be given by an independent assurance provider.

The BRSR Core will be mandatory for the top 1,000 equity listed entities from 2026–2027. SEBI has also mandated the top 250 listed entities by market capitalisation to make ESG disclosures for their top upstream and downstream partners on a comply-or-explain basis from 2024–2025.

SEBI has prescribed additional disclosures in offer documents for issuance of GDS (including environmental objectives of the issuance and details of the project where proceeds are to be deployed), as well as post-listing continuous disclosures on the utilisation of the proceeds, details of unallocated proceeds and performance of the project. To align these disclosure requirements to the ICMA Principles,[85] SEBI has enhanced such disclosures and mandated third-party review of the management of the use of proceeds from GDS and verification of internal tracking and impact reporting.[86]

The SEBI ESG circular mandates mutual funds with ESG schemes to disclose the BRSR and BRSR Core scores of the securities, name of the ERPs providing these scores, and to obtain an independent reasonable assurance regarding the ESG scheme's portfolio's compliance with the strategy and objective.

iii RBI

The RBI survey notes that a majority of the surveyed banks have not aligned their climate-related financial disclosures with the Task Force on Climate-related Financial Disclosures framework (TCFD).[87] RBI has also emphasised the importance of disclosure of climate-related information by entities regulated by RBI in identifying and adapting to climate-related risks and has encouraged adoption of the TCFD by such entities.[88]

iv IFSCA

IFSCA has laid down the standards for fund management entities, managing ESG schemes in IFSC to make certain initial and periodic disclosures including audit reports, performance evaluation and risk management strategies.[89]

v Sustainable finance taxonomy

The current Indian framework has limited definitions for sustainable finance taxonomy.

In this regard, RBI in the Green Deposits Framework, notes that the allocation of proceeds raised from the green deposits should be based on the Indian green taxonomy of green finance. Pending the finalisation of this taxonomy, RBI has specified the list of eligible green activities. Further, SEBI has recently modified the taxonomy of green debt securities in accordance with international standards to include blue, yellow and transition bonds. SEBI has also generally defined 'greenwashing' in the SEBI Greenwashing circular.[90]

ESG data, ratings and reporting

i ESG reporting

Other than the disclosures covered in Section V, no other reporting requirements are required for ESG matters. BRSR has made it mandatory for prescribed Indian companies to provide details of each of the Scope 1, Scope 2 and Scope 3 levels of emission intensity per rupee of turnover of the entity.[91] As discussed in Section V, the BRSR Core comprises enhanced ESG disclosures concerning a set of KPIs under nine ESG attributes including water, energy and greenhouse gas footprint.

It has been noted that an ESG reporting mechanism will improve information management in India, which may further help in reducing maturity mismatches and borrowing costs and improve overall efficiency in resource allocation.[92] Currently, a majority of Indian companies do not have a mandatory obligation to integrate ESG standards or report or disclose their performance in that aspect. However, in the near future, the BRSR report may be required to be mandatorily published by all companies.

ii ESG ratings

To ensure legitimacy of ESG ratings, SEBI has introduced a regulatory framework for ERPs.[93] Only SEBI-certified entities will be permitted to be ERPs.

Currently, the BRSR and the BRSR Core incorporate certain aspects relevant to the just transition, including employee wellbeing, gender diversity and inclusive development. Currently, the Indian regulatory framework does not require entities to provide a transition plan as part of their ESG reporting. However, the ERPs as part of its offering ESG rating product of the transition or *parivartan* score reviews the plans or targets of transition to sustainable operations or net zero emissions target. Other than this, the Indian regulatory framework does not consider any other sustainable or green benchmarks.

Sustainable finance incentives

The government has introduced several schemes and production-linked incentives to promote investments in generation of renewable energy in India.[94] The MNRE has introduced the 'Preference to Make in India' programme in the green energy sector, under which the government and government entities must mandatorily use domestically manufactured goods and services for their renewable energy sector requirements.[95] This preference for domestically manufactured goods and services, with other government incentives such as production-linked incentives for the manufacturing of high-efficiency modules in the renewable energy sector,[96] and fiscal and infrastructure support for research and development in the green energy sector,[97] is expected to boost investor confidence in sustainable finance in India.

Some other incentives for green finance include a subsidy offered to institutional, residential and social sectors on the installation costs of rooftop solar panels,[98] schemes to encourage electric and hybrid vehicle purchase and green shipping by providing financial support.[99]

The government also provides financial support in infrastructure viability gap funding (VGF) for projects that are economically justified but commercially unviable due to large capital investment requirements, long gestation periods and the inability to increase user charges to commercial levels,[100] including the development of battery energy storage systems (BESS).[101]

The Green Credits Programme also incentivises corporates, industries and organisations to undertake specified green activities to earn tradeable green credits.

The government has introduced several policies and incentives across sectors to support sustainable development and also published its plan for long term low carbon development strategy.[102]

Carbon markets and carbon trading

For enhancing energy efficiency in certain designated energy-intensive industries, the Indian regulatory framework has a market-based mechanism of perform achieve and trade (PAT). Under the PAT scheme, designated industries are mandated to reduce their specific energy consumption.[103] These energy savings are then converted to energy saving certificates that are permitted to be traded on Indian energy exchanges.[104]

The Energy Conservation (Amendment) Act, 2022 (the ECA Amendment Act), establishes the framework for creation of the carbon credit market[105] and enables domestic companies to trade carbon credits efficiently and help in meeting India's NDCs by encouraging private sector participation in combating climate change.

A carbon credit trading scheme (CCTS) was also notified in June 2023. A national steering committee will be constituted for the direct oversight and governance of the Indian carbon market and shall, inter alia, identify sectors and potential for reduction of greenhouse gases (GHG) emissions in these sectors and also develop mandatory targets for GHG intensity targets. Entities will be issued carbon credit certificates for their achievement in reducing the GHG emission intensity beyond their assigned targets, while entities that do not achieve their targeted reduction must meet the shortfall by purchasing carbon credits certificates from the Indian carbon market. Currently, entities that are required to meet specified targets have not been notified.

An activity generating green credits under the Green Credits Programme may also get carbon credits from the same activity under CCTS.

Green technology

The ECA Amendment Act makes it mandatory for energy-intensive industries to use a share of non-fossil sources for energy and feedstock, such as green hydrogen, green ammonia, biomass and ethanol.[106]

In 2021, the government launched the National Hydrogen Mission,[107] which set a target of indigenously producing 5 million tonnes of green hydrogen by 2030.[108] It is estimated that an investment of US$100 billion per year will be required to meet this target.[109] ISTS charges have also been waived for specified period for green hydrogen and green ammonia projects.[110] Further, the MNRE provides infrastructural and fiscal support for development of green technology (including biogas and hydrogen),[111] and has granted financial aid to a startup for development of indigenous hydrogen sensing and analysis technology.[112] Following such policy considerations, a number of Indian companies have announced significant investment plans for green and blue hydrogen and ammonia.

India has recognised the importance of carbon, capture, utilisation and storage (CCUS)[113] and the research to develop such technology is underway.[114] To mobilise international finance for CCUS, the government has recognised CCUS as a removal activity for trading of carbon credits under bilateral or cooperative approaches under the Paris Agreement.[115] Further, a VGF scheme for the development of BESS is also in place.[116]

Development of the corresponding regulatory frameworks for emerging green technologies (such as hydrogen, ammonia, CCUS and BESS) is at a nascent stage in India.

Climate change, nature and biodiversity impacts

Risk management

RBI has noted that a physical or transition climate change risk causes credit, liquidity, operational and market risks.[117] RBI is working towards guidelines translating climate risks into quantifiable financial risks and is due to publish disclosure frameworks for climate-related financial risk and guidance on climate scenario analysis and stress testing.[118]

Greenwashing and climate litigation risks

i Greenwashing

SEBI has issued guidelines for issuers of green debt securities to prevent greenwashing.[119] It has encouraged issuers to continuously monitor the use of funds raised for transition towards sustainable operations and assess the environmental impact of their operations. Issuers have been warned against the use of misleading labels, hiding trade-offs and cherry-picking data to highlight green practices while obscuring data that is unfavourable to them.

RBI has also prescribed measures to prevent greenwashing in relation to green deposits, including a third-party verification, assurance and impact assessment report, continuous reporting and disclosure requirements.

Under the SEBI ERPs circular, the ERPs are also mandated to ensure independence of their ESG rating process. Since these guidelines were recently introduced, it is difficult to assess their impact on sustainable finance.

ii Climate-related litigation

While India has not yet seen climate litigation against corporations, the principle of 'polluter pays' has evolved significantly through various cases. In *Indian Council for Environment-Legal Action v. Union of India*,[120] the defendant was ordered to pay compensation to the people affected by environmental deterioration following the absolute liability rule for the damage caused to the environment.

Following orders from the National Green Tribunal,[121] the Central Pollution Control Board released a report[122] that lays down the methodology to assess and recover compensation for environmental damage through the polluter pays principle.

Outlook and conclusions

India has committed to achieving net zero emissions by 2070. Various government departments and institutions have announced schemes and plans towards achieving SDGs and India's NDCs, and Indian companies have announced ambitious investment plans in renewable energy as well as in green ammonia and hydrogen. Indian regulators are increasing their focus on various aspects of sustainable finance, including the amplification of the current sustainable finance taxonomies and introduction of new and innovative market products to promote energy-efficient technologies.

A combination of clear and comprehensive sustainable finance taxonomy, mandatory ESG disclosures, government incentives, innovative financing instruments, deepening of the domestic debt securities market and a sustained policy focus will be required, and will together enable India to achieve SDGs and its NDCs. It is expected that the next few years will see significant developments in the regulatory framework for sustainable finance in India.

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Summary

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Introduction

The Japanese sustainable finance market is not an exception in the context of the rapid growth observed in the global sustainability finance market.

Since 2014, when the first green bonds were issued by a Japanese company,[2] the number of issuances of green bonds deals has increased steadily and reached 99 per year in 2021.[3] The number of issuances of green bonds deals in 2022 was 95, and the total value thereof was recorded to be approximately ¥2,033 billion. Similarly, it was in 2015 when the first sustainability bonds were issued by a Japanese company, and the number of issuances of sustainability bonds deals increased steadily, reaching 40 per year in 2021 (the total value of sustainability bonds issued in 2021 was approximately ¥1,080 billion).[4] Both the number of issuance and value of sustainability bonds slightly decreased in 2022; however, the number of issuances of sustainability bonds deals in 2022 was 35, and the total value of sustainability bonds deals in 2022 was ¥877 billion.

Sustainability-linked bonds are rather new in the Japanese market, and it was only in 2020 when the first sustainability-linked bonds were issued in Japan. However, both the number of deals and the issuance values have grown rapidly, and as at 25 September 2023, the issuance value for sustainability-linked bonds since 1 January 2023 had already exceeded the corresponding statistics of 2022 (full year), and the number of deals had already reached 21 (the number of deals in 2022 (full year) was 13).[5]

The first green loan was introduced in the Japanese market in 2017. Although the green loan market is rather small compared to the green bond market, both in terms of the number of deals and the value, the market has steadily expanded. As at 25 September 2023, 138 green loan deals with a total value in excess of approximately ¥753 billion have been announced in 2023.[6]

It was in 2019 when the first sustainability-linked loans were introduced in the Japanese market. In 2022, the number of deals involving sustainability-linked loans reached 241, and the total value of such loans exceeded approximately ¥657 billion. As at 25 September 2023, the number of deals of such loans announced since 1 January 2023 reached 331.-[7][8]

As for social finance, the number of deals involving social bonds was announced to be 97 in 2022, and the total value of such social bonds issued in 2022 was approximately ¥1,961 billion.[9] No statistical data about social loans is available.

At the same time, the framework of sustainable finance is rapidly developing in Japan. While there is no specific legislation that sustainable finance market players are required to comply with, these players have been voluntarily complying with the guidelines issued by governmental bodies, such as the Ministry of Environment (MOE), the Financial Services Agency (FSA) and the Ministry of Economy, Trade and Industry (METI). The Japanese guidelines are designed to follow the internationally recognised sustainability finance principles released by the International Capital Market Association (ICMA) and the Loan Market Association (LMA), and they have been updated periodically. That is to say, whenever the principles that the Japanese guidelines are based on have been updated. In this regard, the guidelines do not have penalty provisions that are applicable to a case where, for example, an issuer issues certain bonds without complying with the relevant guidelines. The guidelines do not work as hard law, but rather as soft law, and they are respected by the sustainable finance market players.

Year in review

Between 2022 and 2023, there have been various developments in connection with sustainable finance in Japan.

Between 2022 and 2023, there have been various developments in connection with sustainable finance in Japan.

i Cabinet decisions on the Basic Policy for the Realisation of GX (Green Transformation) and the National Strategy on Biological Diversity 2023–2030

The Basic Policy for the Realisation of GX (Green Transformation) was formulated at the end of 2022 based on discussions by the GX Implementation Council established in the Prime Minister's Office and committees from various ministries. The government announced that it would promote primarily the following two initiatives in addition to addressing climate change in order to simultaneously ensure the stable supply of energy and achieve economic growth: (1) promotion of decarbonisation initiatives towards GX, such as switching to decarbonised energy sources that contribute to improving the self-sufficiency rates of energy, such as renewable energy and nuclear power, in order to ensure stable energy supply in addition to thorough improvement of energy efficiency, and (2) realisation of the 'Pro-Growth Carbon Pricing Concept', which includes bold advance investment support using 'GX Economy Transition Bonds', incentives for GX investment through carbon pricing and utilisation of new financial instruments. For details of the status of the carbon markets and carbon trading system in Japan, see Section VIII.

The National Strategy on Biological Diversity 2023–2030, which was drafted based on the Kunming-Montreal Global Biodiversity Framework adopted at COP15 in December 2022, was announced in March 2023. See Section X for details.

ii Enactment of the disclosure rules regarding sustainability information

The amended regulations were enacted to require listed companies to disclose sustainability information in their annual securities reports under the Financial Instruments and Exchange Act (FIEA) and the initial mandatory disclosures on these matters were made via annual securities reports for the fiscal year ending March 2023. For details of this development, see Section V.

Regulation and policy

i Governance regime

Japan had promoted various initiatives on carbon neutrality even before the Paris Agreement came into effect. For instance, in July 2015, Japan submitted to the United Nations Framework Convention on Climate Change Secretariat its nationally determined contribution target to reduce greenhouse gas emissions in 2030 by 26 per cent from 2013 levels. To further accelerate these efforts after the entry into force of the Paris Agreement, then Prime Minister Yoshihide Suga declared in his policy speech in October 2020 that Japan will aim for carbon neutrality by 2050. Under the Suga administration, domestic efforts to decarbonise have made rapid progress, with the announcement of an ambitious goal of a 46 per cent reduction in greenhouse gas emissions in 2030 (compared to 2013 levels), which is consistent with the goal of carbon neutrality in 2050.

Under the current Kishida administration, decarbonisation continues to be an important policy issue for Japan. In Prime Minister Fumio Kishida's policy speech in December 2021, he stated: 'We will forge our clean energy strategy by grasping both the supply and the demand sides in an integrated manner, including innovations and capital investments not only in energy supply but also on the demand side.'

In terms of the sustainable development goals (SDGs), generally speaking, after the adoption of the SDGs by the UN Sustainable Development Summit held in September 2015, the Japanese government established the SDGs Promotion Headquarters in May 2016, which is headed by the Prime Minister, to effectively achieve the SDGs. In December 2016, the SDGs Implementation Guiding Principles were established. The Principles, revised in December 2019, are part of a mid- to long-term national strategy for achieving the SDGs in Japan and internationally by 2030.

ii Regulators

Sustainable finance policies in Japan involve a variety of organisations, including ministries, government agencies and private sectors. Here, we introduce some of the most important organisations and list the main frameworks, principles, documents and policies in relation to sustainable finance that they have developed.

The FSA developed:

1. the Stewardship Code (2014, revised in 2017, 2020);
2. the Corporate Governance Code (2015, revised in 2018 and 2021);
3. the Social Bond Guidelines (2021); and
4. the Basic Guidelines on Climate Transition Finance (2021, jointly with METI and MOE).

The MOE developed:

1. the Green Bond and Sustainability-Linked Bond Guidelines (2017, revised in 2020, 2022);
2. the Green Loan and Sustainability-Linked Loan Guidelines (2020, revised in 2022);
3. the Basic Concept of Impact Finance (2020); and
4. the Green Impact Assessment Guide (2021).

The METI developed:

1. the Guidance for Integrated Corporate Disclosure and Company-Investor Dialogues for Collaborative Value Creation (2017, revised in 2022);
2. the Guide for SDG Business Management (2019);
3. the Climate Innovation Finance Strategy (2020); and
4. roadmaps of transition finance for each industrial sector.

The Tokyo Stock Exchange developed:

1. the Corporate Governance Code (2015, revised in 2018 and 2021); and
2. the Practical Handbook for ESG Disclosure (2020).

Other than the above, the Ministry of Land, Infrastructure, Transport and Tourism has outlined roadmaps on transition finance focusing on the transportation industrial field. In addition, various industrial associations, such as the Japan Securities Dealers Association and Japanese Bankers Association, have compiled various proposals and reports in relation to bonds and loans, respectively.

Sustainable finance instruments

i Types of sustainable finance instruments

In Japan, instruments of sustainable finance have been constantly developed in accordance with the study and practice of other markets. There are several types of environment-related financing instruments, as follows. Green finance is used to finance green projects (projects related to renewable energy, energy conservation, clean transportation, etc.); sustainability finance, funds of which are used for both green projects and social projects, is used to finance sustainability projects; and sustainability-linked finance, which encourages the realisation of ambitious sustainability performance targets (SPTs) in light of the fact that financial or structural characteristics, or both, can vary depending on whether the issuer achieves the SPTs. In addition to these, a new category called transition finance has emerged in recent years to promote financing for steady low carbon initiatives, such as energy conservation in sectors where greenhouse gas emissions are difficult to reduce, and for transition initiatives, such as long-term research and development of decarbonisation. There is also growing interest in blue finance, which uses funds for a specific purpose that involves the aquatic environment, such as preventing marine pollution and protecting marine resources. From a social-related perspective, social finance is used to finance social projects (projects related to infrastructure development, childcare and nursing care support, employment and the health of employees, etc.).

These types of financing mainly take two forms: one is to raise funds from capital markets by issuing bonds, and the other is to raise funds through loans from financial institutions (mainly banks). In addition to bonds, there can also be equity finance in the form of stocks and other securities.

However, these types may overlap, which makes them difficult to categorise. Therefore, in Japan, as described in the next section, principles and guidelines have been developed based on international principles and guidelines, and the requirements for each type of financing and its relationship with the other types of financing have been organised. Taking the relatively new transition finance as an example, the Basic Guidelines on Climate Transition Finance labels three categories of financial instruments as transition finance:

1. financial instruments (bonds or loans) that meet the four elements[10] of disclosure recommended in the Climate Transition Finance Handbook by ICMA and the proceeds of which shall be used for specific purposes (when the proceeds are not used for green projects but the process follows the existing principles and guidelines);
2. financial instruments (bonds or loans) that meet the four elements, set targets in line with the transition strategy and change their financial or structural characteristics, or both, depending on the achievement of predefined targets, and the proceeds of which can be used for general corporate purposes; and
3. financial instruments that meet the four elements and follow the existing Green Bond Principles and the Green Bond Guidelines (when the proceeds are used for green projects).

The guidelines also noted that regardless of (a) to (c) above, financial instruments that fulfil the four elements of transition finance may be recognised as transition finance.

ii Principles and guidelines

There is no legislation in Japan that defines the criteria and requirements for specific types of green finance, social finance, sustainability finance, sustainability-linked finance or transition finance. However, the following principles and guidelines have been developed by relevant Japanese ministries in accordance with international ones for reference in arranging such financing.

Contrast chart in respect of bonds

Type of bond	ICMA	Japan
Green bond	Green Bond Principles	Green Bond Guidelines
Social bond	Social Bond Principles	Social Bond Guidelines
Sustainability bond	Sustainability Bond Guidelines	Green Bond Guidelines[11] and Social Bond Guidelines[12]
Sustainability-linked bond	Sustainability-Linked Bond Principles	Sustainability-Linked Bond Guidelines
Transition bond	Climate Transition Finance Handbook	Basic Guidelines on Climate Transition Finance

Contrast chart in respect of loans

Type of loan	LMA and others	Japan
Green loan	Green Loan Principles	Green Loan Guidelines
Social loan	Social Loan Principles	–
Sustainability loan	–	–
Sustainability-linked loan	Sustainability-Linked Loan Principles	Sustainability-Linked Loan Guidelines
Transition loan	–	Basic Guidelines on Climate Transition Finance[13]

Each of the principles and guidelines provide four or five core components. The core components that the principles and guidelines for green social, and sustainability finance have in common are 'use of proceeds', 'process for project evaluation and selection', 'management of proceeds' and 'reporting'. The reporting component is also a core component of sustainability-linked finance; however, as proceeds of sustainability-linked finance can be used for general purposes, use of proceeds is not one of its core components. Rather, as sustainability-linked finance is a financial instrument for which the financial or structural characteristics, or both, can vary depending on whether the issuer achieves predefined sustainability targets, 'selection of key performance indicators', 'calibration of sustainability performance targets', 'bond/loan characteristics' and 'verification' are provided as key components in the principles and guidelines.

It is noteworthy that the latest Green Bond Guidelines and Green Loan Guidelines provide viewpoints in judging whether a certain project has a clear improving effect on the environment, which are not seen in the Green Bond Principles and the Green Loan Principles.

These principles and guidelines are not legal norms; therefore, no legal penalties will be imposed if, for instance, financing labelled as a green bond does not meet some of the elements of the Green Bond Principles by ICMA and the Green Bond Guidelines by MOE. However, the main purpose of these principles and guidelines is to ensure the market's confidence in these types of financing by acting as a check against bonds and loans that may be traded as 'greenwashing', which are bonds and loans that may be perceived as being green despite having no environmental benefits. Since the goal is to ensure confidence in financing and to attract sufficient funds from the market, market players voluntarily originate bonds and loans in compliance with these principles and guidelines, and it has become common practice to do so in Japan.

Sustainable disclosure requirements and taxonomy

i Disclosure by companies

In Japan, under the FIEA, listed companies and certain other companies generally must file annual securities reports with the local finance bureau within three months of the end of each fiscal year. In June 2022, the disclosure working group published a report proposing to amend the disclosure requirements for annual securities reports under the FIEA to introduce a new section for the disclosure of sustainability information. Based on the report, the amendments to the disclosure rules under the FIEA were enacted, and the initial mandatory disclosures on these matters were made via annual securities reports for the fiscal year ending March 2023. The new section comprises four elements: governance, strategies, risk management and metrics and targets that are based on the framework of the TCFD and the sustainability disclosure standards of the International Sustainability Standards Board (ISSB). The new disclosure rules provide that the disclosure of strategies and metrics and targets should be required only if the relevant reporting company has determined that they are material, while governance and risk management should be disclosed by all reporting companies. Among various sustainability issues, the discussion by the disclosure working group focused on climate change, human capital and diversity. For climate change, the new disclosure rules under the FIEA provide no specific disclosure standard, but the Sustainability Standards Board of Japan is currently developing the sustainability disclosure standards based on the ISSB disclosure standards. According to the FSA's roadmap announced in December 2022, the sustainability disclosure standards to be established by the Sustainability Standards Board of Japan are expected to be incorporated into the disclosure rules under the FIEA in the future. For human capital and diversity, the new disclosure rules under the FIEA provide that human resource development policies, policies on improving the workplace environment, gender pay gap, ratio of women in managerial positions and ratio of male workers taking childcare leave were added to the disclosure items.

In addition, the Tokyo Stock Exchange revised the Corporate Governance Code in June 2021. The Code adopts a principle-based approach, under which each listed company is to substantively interpret and apply the Code according to its own circumstances without being limited by the text of the Code itself. The revised Code provides that companies should appropriately disclose their initiatives on sustainability when disclosing their management strategies. In particular, the Code provides that companies listed on the Prime Market should collect and analyse the necessary data on the impact of climate change-related risks and earning opportunities on their business activities and profits, and enhance the quality and quantity of disclosure based on the TCFD recommendations or an equivalent framework that includes the ISSB disclosure standards.

ii Disclosure by investors

In contrast to these corporate level disclosures, legal requirements for the disclosure of sustainability information by asset managers or asset owners, or on an investment product basis, have not been introduced yet in Japan; however, the following initiatives are being developed.

In terms of disclosure by investors, in March 2020, the Stewardship Code of Japan was revised to address sustainability considerations, including that institutional investors should clearly specify how they take the issues of sustainability into consideration in their stewardship policy, corresponding to their investment management strategies. Further, in June 2023, the Expert Panel on Sustainable Finance of the FSA published the third report on the direction of policy measures for sustainable finance. The report emphasises that the FSA will share knowledge on measures to increase the growth and sustainability of assets under management by institutional investors while taking into account the challenges of each institutional investor. The FSA also expects that stakeholders, including beneficiaries, asset owners, asset managers and investee companies, will discuss sustainability among themselves.

For ESG mutual trusts, in May 2022, the FSA published its supervisory expectations for asset managers that provide ESG mutual trusts. Based on this, the FSA's supervisory guidelines for financial instruments business operators were revised in March 2023. The revisions set out the points that the FSA considers for the supervision – such as the scope of ESG mutual trusts, appropriate disclosures regarding ESG mutual trusts and establishment of organisational structure – by asset managers.

iii Taxonomy

A taxonomy for sustainability and ESG has not been introduced in Japan.

ESG data, ratings and reporting

i Reporting by companies

As discussed in Section V, the disclosure rules under the FIEA provide that strategies and metrics and targets with respect to sustainability are only required to be disclosed in annual securities reports if the relevant reporting company has determined that they are material. There is no legal requirement to disclose information on greenhouse gas emissions in annual securities reports; however, the FSA expects that reporting companies proactively disclose information on Scope 1 and 2 greenhouse gas emissions, considering the materiality of the information based on the relevant companies' business models and business environment. While this expectation on the part of the FSA does not include Scope 3 greenhouse gas emissions, there was discussion by the members of the disclosure working group to the effect that information on Scope 3 greenhouse gas emissions is useful.

The Act on Promotion of Global Warming Countermeasures requires certain business operators that produce considerably high greenhouse gas emissions to report to the government information on Scope 1 and 2 greenhouse gas emissions, and the government publishes the information annually. This measure is not for the purpose of disclosure to investors but is a regulatory purpose for global warming countermeasures.

ii ESG evaluation and data providers

Recently, the role of ESG evaluation and data providers has been increasingly important based on the expansion of sustainable finance. The providers' evaluations and data are used for, among other things, decisions on investment in securities by institutional investors, creation of ESG indices and engagement with companies. In December 2022, the FSA published Code of Conduct for ESG Evaluation and Data Providers. The Code addresses issues regarding ESG evaluation and data providers, such as transparency of evaluations and potential conflicts of interest. The Code does not constitute laws or regulations that uniformly require all ESG evaluation and data providers to comply with the Code, but rather is designed to be a voluntary code on a principle basis, where the FSA calls for providers to express their support for the Code, and the providers that support the Code either comply with the Code or explain the reasons for their non-compliance with a particular item. The Code sets forth principles, guidelines and concepts with respect to various matters, such as securing the quality of the service of ESG evaluation and data provision; managing independence and conflicts of interest; and ensuring transparency of methodologies and processes for the evaluation.

Sustainable finance incentives

The government offers various kinds of incentives to promote sustainable finance.

The government offers various kinds of incentives to promote sustainable finance.

i Financial incentives for costs for second-party opinions of sustainable finance issuers

MOE and METI, through their outside executive body, provide subsidies to rating agencies that provide second-party opinions to sustainable finance issuers, or to consulting firms that provide various consulting services for green finance. By the government's provision of the aforementioned subsidies, companies that intend to raise funds through sustainable finance are relieved of the burden of costs for the second-party opinions required under the relevant principles and guidelines. These financial incentives are intended to make it easier for the companies to utilise sustainable finance instruments.

ii Transition finance interest subsidy

METI has offered an interest subsidy project for transition loan borrowers since 2021. The borrowers are required to:

1. obtain certification by an outside rating agency that the transition loan satisfies both the Basic Guidelines on Climate Transition Finance and the Sustainability-Linked Loan Guidelines; and
2. apply for and obtain certification of their plan from the certified government ministry.

METI will offer the interest subsidy in relation to approximately ¥1 trillion in loans in total, for a period of three years.

iii Development of roadmaps for promoting transition finance

METI developed a roadmap to provide a concrete direction for the transition toward achieving carbon neutrality in 2050 for greenhouse gas-intensive industries. METI has released roadmaps for eight industrial sectors. In other industrial sectors, such as the international shipping, domestic marine transport and aviation sectors, there are roadmaps and other documents, issued by the Ministry of Land, Infrastructure, Transport and Tourism, which indicate technologies and directions toward carbon neutrality that can be used or followed for transition finance.

It is assumed that companies will refer to the roadmap when considering climate change measures using transition finance. The roadmap is expected to assist financial institutions in determining whether a company's strategies and initiatives toward carbon neutrality qualify for transition finance when the company raises funds.

Carbon markets and carbon trading

In February 2023, the Japanese government announced the introduction of an emissions trading system under its basic policy for the realisation of GX (Green Transformation) to achieve its goal of carbon neutrality by 2050. The full-scale operation of the emissions trading system is scheduled to begin in fiscal year 2026, and in connection with this, the Tokyo Stock Exchange established a carbon credit market in October 2023. Currently, the only item eligible for trading in the carbon credit market is J-Credits, which are administered by the Japanese government.

Green technology

i Green innovation fund

Toward the goal of achieving carbon neutrality by 2050, it is necessary to make structural changes in the energy and industrial sectors and to invest in green innovation. In 2021, METI established the green innovation fund, a ¥2 trillion fund, as part of the New Energy and Industrial Technology Development Organisation. The green innovation fund supports, for 10 years, companies and other organisations that will implement projects that are aimed at realising ambitious 2030 targets (performance, amount of installation, price, CO_2 reduction rate, etc) in the priority fields for the government's green growth strategies. The priority fields include offshore wind power, solar power, geothermal power, hydrogen and fuel ammonia. The eligible project must include innovative and fundamental R&D elements that are worthy of being commissioned by the government.

The green innovation fund requires persons in management at companies and other organisations seeking support to show their commitment to tackling the 2030 targets as management issues. To secure this, the green innovation fund may terminate support and require a partial refund of commission fees if the relevant companies or other organisations are not sufficiently committed to such efforts; and the fund introduces incentive measures, such as contingent fees depending on goal achievement levels and other criteria.

ii Digitally tracked green bonds

In June 2022, JPX Market Innovation & Research, Inc, an affiliate of Japan Exchange Group, Inc, issued digitally tracked green bonds through a security token offering. The bonds utilise blockchain technology to improve transparency of data and efficiency of data collection, thereby addressing issues that have been raised by both issuers and investors of green bonds around the transparency of data and complexity of the data collection process needed for green investments. The mechanism automatically measures the amount of power generated by renewable power generation facilities, converts it into an amount of CO_2 reduced and records on a security token platform the amount of generated power and reduced CO_2. The investors can access the data recorded, and thereby the transparency and efficiency of green projects are expected to improve.

Climate change, nature and biodiversity impacts

i Progress in reduction of greenhouse gas emissions

As discussed in Section III, in 2021 the government announced its ambitious goal of a 46 per cent reduction in greenhouse gas emissions by 2030 (compared to 2013 levels). According to the progress report issued by Global Warming Prevention Headquarters on 30 June 2023, the total volume of greenhouse gas emissions in fiscal year 2021 was reduced to 1.1 billion t-CO_2e, which is approximately 80 per cent of the total volume of greenhouse gas emissions in fiscal year 2013 (i.e., an approximately 20 per cent reduction has been achieved).

ii Climate and transition risk management frameworks

At the time of writing, there is no legislation or any guidelines in Japan prescribing rules for climate and transition risk management frameworks with which companies in general are required to comply. In July 2022, the FSA published Supervisory Guidance on Climate-Related Risk Management and Client Engagement, which provides viewpoints in supervisory dialogues with financial institutions regarding their climate-related risk management and their engagement with clients to support the responses of clients to climate-related opportunities and risks. This guidance is non-binding and serves as a baseline for supervisory dialogues between the FSA and financial institutions.

See Section V for the disclosure requirements regarding risk management in the context of disclosure of sustainability information by reporting companies.

iii Nature and biodiversity risk management frameworks

There is various legislation in Japan targeting preservation of the natural environment and biodiversity. In particular, the Basic Act on Biodiversity, which was enacted in June 2008, is basic legislation targeting the preservation of biodiversity. In March 2023, the Japanese government announced the National Strategy on Biological Diversity 2023–2030, which was compiled based on the Kunming-Montreal Global Biodiversity Framework adopted at COP15 in December 2022. The National Strategy on Biological Diversity 2023–2030 sets a target of realising 'nature positive' by 2030 and provides 40 targets in five basic policy categories.

Greenwashing and climate litigation risks

i Greenwashing

As discussed in Sections IV, V, and VI, while a taxonomy for sustainability and ESG has not been introduced in Japan, the Japanese government has taken various measures to prevent 'greenwashing', such as revising the sustainability finance guidelines, the requirements pertaining to sustainability disclosure by listed companies, the supervision of ESG mutual trusts and the establishment of the Code of Conduct for ESG evaluation and data providers.

ii Climate change-related litigations

Unlike in the US or in Europe, there has been no noteworthy litigation directly requesting the government or Japanese companies to take certain actions for climate change (e.g., litigation alleging that the government policy on climate change is not sufficient or litigation requesting a company to take certain effective actions to reduce its volume of greenhouse gas emissions). There are, however, several cases pending in Japan requesting an injunction against the operation or construction of coal-fired power plants.

Outlook and conclusions

To achieve the goal of carbon neutrality by 2050, the government is formulating various measures to vitalise the sustainable finance market. In addition, as it is key for listed companies to provide investors and other stakeholders with sufficient sustainability information to improve their corporate value, the formulation of the rules and guidelines relating to the disclosure of sustainability information is progressing rapidly.

It will be important for sustainable finance market players, including their advisers, to pay close attention to movements concerning sustainable finance and sustainability information disclosures.

Endnotes

1 Hiromi Hattori and Yuichi Miyashita are partners at Nagashima Ohno & Tsunematsu. ^ Back to section

2 These green bonds were issued by the Development Bank of Japan Inc. ^ Back to section

3 http://greenfinanceportal.env.go.jp/en/bond/issuance_data/market_status.html. ^ Back to section

4 http://greenfinanceportal.env.go.jp/en/bond/issuance_data/market_status.html. ^ Back to section

5 http://greenfinanceportal.env.go.jp/en/bond/slb_issuance_data/slb_market_status.html. ^ Back to section

6 http://greenfinanceportal.env.go.jp/en/loan/issuance_data/market_status.html. ^ Back to section

7 http://greenfinanceportal.env.go.jp/en/loan/sll_issuance_data/sll_market_status.html. ^ Back to section

8 According to the statistical data, the total value of such loans since 1 January 2023 had not increased in proportion to the growth in the number of deals, however, that is because recently the number of deals where the value of the loan is not disclosed increases. ^ Back to section

9 https://www.jsda.or.jp/sdgs/hakkou.html. ^ Back to section

10 The Climate Transition Finance Handbook by ICMA provides four elements (Element 1: issuer's climate transition strategy and governance; Element 2: business model environmental materiality; Element 3: climate transition strategy to be 'science-based' including targets and pathways; and Element 4: implementation transparency). ^ Back to section

11 The Green Bond Guidelines apply to sustainability bonds to the extent that the proceeds of the sustainability bonds are allocated to green projects. ^ Back to section

12 The Social Bond Guidelines apply to sustainability bonds to the extent that the proceeds of the sustainability bonds are allocated to social projects. ^ Back to section

13 While these guidelines are written based on cases for bonds, the relevant concepts can also be applied to loans. ^ Back to section

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Introduction

In less than 15 years, Luxembourg has become a well-known and highly regarded hub for environmental, social and governance (ESG) sustainable finance instruments.

This success story began in 2017 with the issuance of the first green bond by the European Investment Bank, called a climate awareness bond. As for other ESG products, the rise of Luxembourg sustainable finance instruments is the result of a combination of factors: a clear and flexible national legal regime, notably in the issuance of debt instruments; the combination of European and national regimes with respect to listing venues; and the strong commitment and cooperation of Luxembourg political parties, regulators and market players to greening the financial system.

To date, the Luxembourg Green Exchange created by the Luxembourg Stock Exchange lists approximately 1,804 sustainable instruments split across green, social, sustainability and sustainability-linked bonds.[2] Their aggregate issuance is approximately €920 billion.-[3]

As at October 2023, more than 50 per cent of green bonds worldwide were listed on the Luxembourg Stock Exchange.[4] The country's green trajectory is fully supported by government initiatives, so much so that in 2020, Luxembourg became the first European and triple A-rated state to issue a sustainable bond.[5]

Luxembourg's financial sector generally derives its ground rules from European legislation, and sustainable finance is no exception to this.

The most important text laying the foundations for the new sustainable finance framework and setting the scene for sustainable engagement in the European financial world is the Action Plan on Sustainable Finance, published by the European Commission in March 2018 (the Action Plan).[6] The Action Plan set sustainability targets and initiated the main subsequent directives and regulations, targeting all financial market participants and cutting across every aspect of financial services provision (and beyond).

The regulatory offspring of the Action Plan has been plentiful:

1. Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR);
2. Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (EU Taxonomy);
3. the revision of the framework of both Directive (EU) 2011/61 (AIFMD) and Directive (EU) 2009/65 (the UCITS Directive);
4. the update of the CRR,[7] MiFID II,[8] Solvency II Directive[9] and IDD[10] frameworks;
5. Regulation (EU) 2019/2089 amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks;
6. the Corporate Sustainability Reporting Directive (CSRD)[11] amending the existing Directive 2014/95/EU on disclosure of non-financial and diversity information by certain large undertakings and groups (NFRD);[12]
7. the first set of the related European Sustainability Reporting Standards (ESRS);[13] and

8. the proposal for a Corporate Sustainability Due Diligence Directive (CSDDD).

These texts have been supplemented by regulatory technical standards (RTS) and implementing technical standards (ITS) adopted by the European Commission, by guidance, reports, opinions and discussion papers published, inter alia, by the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA), as well as by local implementing rules (where applicable) and regulations adopted under national law or issued by Luxembourg supervisory authorities.

Ever since, market practice in Luxembourg has gradually become clearer: those who do not wish to be part of the sustainability transition must be fully transparent about this fact (and, as a result, few financial market players have opted for that position). The asset management world was the first to undergo a significant shift towards more sustainability, initially on the retail side and then in the private universe. Other fields of finance later followed suit.

The Commission de Surveillance du Secteur Financier (CSSF), Luxembourg's supervisory authority for the financial sector, was quick to set clear expectations while maintaining constant dialogue with the industry. Luxembourg's supervisory authority for the insurance sector, the Commissariat aux Assurances (CAA), has issued valuable guidance as well.

Luxembourg has also set ambitious long-term goals for sustainability in general, as follows.

1. Luxembourg is committed to the Paris Agreement on global warming and to the 17 sustainable development objectives set by the United Nations in the 2030 Agenda.
2. Following the objectives set in the Paris Agreement, Luxembourg aims to reduce its own greenhouse gas emissions for the sectors outside the emissions trading scheme by 55 per cent by 2030 compared to 2005. For this purpose, Luxembourg adopted the Law of 15 December 2020 on the climate, amending the amended Law of 31 May 1999 establishing an environmental protection fund. This Law imposes gas emissions reductions on the following sectors: energy and manufacturing industries, construction, transport, residential and tertiary buildings, agriculture and forestry, and waste and wastewater treatment.
3. Luxembourg has implemented the 10 priority fields of action defined by the National Plan for Sustainable Development and the National Integrated Energy and Climate Plan.[14]
4. Luxembourg is very ambitious regarding its energy sovereignty, and aims to increase its share of renewable energy from 11 to 25 per cent by 2030.
5. The Luxembourg Ministry for Foreign and European Affairs, together with the Luxembourg Union of Enterprises and the National Institute for Sustainable Development and Corporate Social Responsibility (INDR), recently launched a new instalment of the National Business and Human Rights Pact,[15] a voluntary initiative for Luxembourg enterprises willing to commit to aligning with the United Nations Guiding Principles on Business and Human Rights.

The maturity of the Luxembourg business and regulatory ecosystem is also shown by the recent launch by the Chamber of Commerce, in partnership with the INDR, of the Luxembourg House of Sustainability, a platform that aims to bring together, coordinate and facilitate the efforts of Luxembourg private and public market players in the transition to a sustainable economy.[16]

Other national institutions are also active in this area and have applied a range of sustainability principles internally. For example, the Chamber of Commerce is implementing the principles described in its publication Luxembourg Sustainable Business Principles – Our common 2030 goal.[17]

Year in review

i General financial sector developments

In Luxembourg, and throughout the European Union, the past year has been occupied with clarifying the various requirements of the SFDR, the EU Taxonomy and other legislation, and proposing practical solutions for meeting them.

The CSSF has been proactive in offering practical means of implementing the EU's regulatory framework for sustainable finance. In particular, it has created an accelerated examination process in view of the entry into force of the SFDR Level II rules (as defined below) on 1 January 2022: in July 2022, the CSSF issued a communication informing financial market participants that, although it would require updated, compliant documents by 31 October 2022 for financial products under its supervision, these documents could be fast-tracked for examination and approval under certain conditions.

This was just one of many efforts to manage the major implementation challenge faced by the country due to the size of its financial industry. Another was the CSSF's rapid response to the publication on 25 March 2022 of the final draft of Commission Delegated Regulation (EU) 2022/1288 setting out the regulatory technical standards relating to the SFDR (the SFDR RTS). Taking a forward-looking approach, the CSSF communicated on 1 April 2022 that: 'In line with the ESAs' Updated Supervisory Statement, the CSSF encourages financial market participants and financial advisers to use the draft RTS as a reference for the purposes of applying the provisions of Articles 2a, 4, 8, 9, 10 and 11 of the SFDR and Articles 5 and 6 of the [EU Taxonomy] in the interim period until the [SFDR] RTS are adopted by the European Commission.'

The CSSF has also continually raised awareness on ESG-related legislative developments. One example of this is its communication of 15 June 2022 drawing the local market's attention to two European Commission Q&As (of July 2021 and May 2022), the ESMA Supervisory Briefing (of 31 May 2022) and the European Supervisory Authorities' clarification statement (of 2 June 2022) on the SFDR RTS.

The CSSF also kept the industry informed of deadlines and upcoming regulatory developments that had happened or were still in the pipeline. A good example of that approach to accompanying the market through regulatory challenges is the communication to the investment fund industry on regulatory requirements concerning the SFDR and the upcoming entry into force of the SFDR RTS,[18] where the CSSF reminded financial market players of upcoming deadlines but also announced its intention to launch a dedicated data collection exercise to digitally collect key information on ESG compliance.

In its 2021 and 2022 annual reports, the CSSF repeatedly highlighted the role and importance of sustainable finance, and issued a series of related educational videos. In the same vein, in April 2023, the CSSF published the list of its supervisory priorities in the area of sustainable finance, in which the CSSF specified its supervisory focus areas regarding ESG matters for credit institutions, asset managers, investment firms and issuers and indicated that 'the primary responsibility of ensuring compliance with applicable requirements lies with the supervised entities and their board members, who should ensure that the integration of ESG factors in traditional governance, risk management and compliance tools is a focal point within their organisations, and endeavor to make suitable ESG education a priority for themselves and their personnel'.[19]

In February 2023, the CSSF also launched its ambitious data collection exercise, the first phase of which mainly focused on collecting information with regard to the organisational arrangements of investment fund managers in relation to ESG requirements under the SFDR.[20] On 24 March 2023, the CSSF published another communiqué announcing the extension of this data collection exercise to shift the focus of the exercise to product-level information.[21] The scope was finally extended to periodic product reports, with a deadline set for 2024.

In light of the data gathered, the CSSF has, inter alia, issued a specific FAQs document for the SFDR[22] which was aimed at providing guidance on several aspects of the regulation. The regulator also published a comprehensive public report[23] on how successfully the SFDR was implemented by asset managers in Luxembourg.

ii Banking and insurance-specific developments

2020, 2021 and 2022 have been years of breathtaking change for banks and insurance undertakings when it comes to ESG requirements.

Key milestones at the national level include the following.

In 2020 and 2021, the CSSF amended and adopted key circular letters to integrate ESG risk exposures into banks' overall business strategies, risk management frameworks and internal governance arrangements.[24]

In February 2022, Luxembourg adopted the law of 25 February 2022 implementing a range of sustainability legislation, including the SFDR and the EU Taxonomy (Implementing 2022 Law). In particular, the Implementing 2022 Law designates the Luxembourg authorities responsible for supervising the proper implementation of the SFDR and the EU Taxonomy in the banking and insurance sectors.

In July 2022, Luxembourg adopted the Grand Ducal Regulation of 27 July 2022 amending the amended Grand Ducal Regulation of 20 May 2018 on the protection of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits (GDR 2022). The GDR 2022 served to implement the product governance requirements imposed under the Commission Delegated Directive 2021/1269 amending the Commission Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into product governance obligations.

In August 2022, the CSSF issued a series of press releases, in particular to call attention to the application deadlines for the new sustainability requirements pertaining to the integration of sustainability preferences into suitability assessments.[25]

In the same month, the CAA published an information notice emphasising the regulatory challenges linked to sustainable finance.[26]

In September 2022, the CSSF published the results of a public survey that assessed the knowledge and perception of sustainable finance among Luxembourg households. According to the survey, the public generally agreed that the financial sector can have a positive impact on the development of renewable energy, local communities, climate and the environment, but it lacked detailed knowledge of what constitutes sustainable finance. The survey further emphasised the importance of educational action and the key role of the banker in this regard.[27]

The aforementioned survey illustrates a principal near-term challenge for the banking and insurance sectors: to remediate the sustainability knowledge gaps of their clientele. To achieve this, market players must ensure that relevant staff and key function holders are adequately trained to understand the new concepts and rules as they emerge, and that their businesses can implement and adjust to the ever-evolving regulatory requirements around sustainable finance.

In January 2023, the CAA published an additional information notice, which analysed how the integration of climate-related risks into the Own Risk and Solvency Assessment (ORSA) report has evolved over the years 2019 and 2021 and in which the CAA highlighted both the efforts already made and those that remain to be undertaken by the industry to be fully compliant with the relevant regulatory requirements.[28] More generally, the CAA specified in its 2022 Annual Report that control of arrangements set up by insurance and reinsurance undertakings and their intermediaries to comply with the regulatory requirements applicable to sustainable finance has been included on the list of the CAA's supervisory priorities for 2023.[29]

In 2023, the CSSF also conducted self-assessment exercises with samples of banks on compliance with transparency and risk management obligations, to provide banks with guidance on the concrete actions that are required in practice for the implementation of these obligations. A dedicated webinar was organised, together with industry representatives, to present the outcome of the sustainability risk self-assessment.[30]

Regulation and policy

i Governance regime

Governance is, as a matter of principle, a subject to which Luxembourg regulators pay meticulous attention, with frequent on-site inspections of financial sector players performed to verify the adequacy of their governance mechanisms.

In today's regulatory environment, sustainability considerations impact these mechanisms directly. Boards in particular have a pivotal role to play in this respect.

From a Luxembourg law perspective, the board of directors is the body ultimately responsible for the sound and prudent management of undertakings and their compliance with applicable laws, regulations and administrative guidelines.[31]

To date, there is no general obligation under Luxembourg corporate law for boards to take action in the direct interest of their company's external stakeholders. Board members are obliged to act in the best interests of the company, and it is to the company that their fiduciary duty is due.

However, companies listing their shares on the Luxembourg Stock Exchange are subject to the 'X Principles of Corporate Governance of the Luxembourg Stock Exchange' (the X Principles).[32] The X Principles include three sets of rules: the actual mandatory principles, which are complementary to Luxembourg legislation and cannot deviate from or contradict its provisions; the related recommendations, which are issued on a comply-or-explain basis; and the guidelines, which are indicative and not binding.

With respect to fiduciary duties, Principle 2 of the X Principles provides that the board, as a collective body, must act in the corporate interest, and must serve all the shareholders by ensuring the company's long-term success. However, board members must also consider corporate social responsibility (CSR) aspects and take into account the interests of all stakeholders in their deliberations. Recommendation 2.3 further provides that the board must consider all CSR aspects of the business when defining the company's values. Furthermore, Principle 9 requires companies listed on the Luxembourg Stock Exchange to define a CSR policy that includes social and environmental responsibilities. In the creation of long-term value for the company, directors are recommended to integrate CSR aspects (Recommendation 9.2) and to consider the company's non-financial risks, including social and environmental risks (Recommendation 9.3), as well as to establish a specialised CSR committee as part of sound corporate governance (Guideline 2 on Recommendation 9.3).

While the X Principles are mandatory only for listed companies, their recognised prestige in the market makes them a clear point of reference for private companies as well. More generally, the shifting regulatory landscape and the foreseeable disruptions that climate change will continue to bring about make it necessary to revise the traditional interpretation of the fiduciary duties of company directors. In the current environment, the sustainability of business and governance models has ceased to be a corollary of CSR and has become a tool for risk mitigation and management. While for private companies the hard law requirements are still pinned to the traditional principle of shareholder primacy, sound corporate governance principles, the risk of exclusion from supply chains and pressure from activist shareholders and stakeholders are pushing Luxembourg boards to commit to sustainability, establish sustainability policies and take part in voluntary initiatives.

Among these initiatives, the ESR label issued by the Luxembourg INDR[33] is noteworthy: under this label, a company that satisfies certain sustainability parameters may qualify as a socially responsible enterprise. The ESR label is granted following a self-evaluation by the company, paired with an assessment by the INDR and subsequent monitoring focused on shortcomings and the implementation of CSR commitments (also subject to independent audit).

Whether a company's goal is to conspicuously excel at voluntary initiatives or merely to reduce external pressure, the application of sound corporate management rules and prudent governance principles will invariably call for an expansive interpretation of its directors' fiduciary duties (which must now go far beyond the duty to maximise short-term profits for shareholders).

Today's boards are tasked with ensuring that all relevant ESG requirements are properly implemented across corporate governance levels and functions. This means that board members must acquire or keep ready access to the range of ESG knowledge, experience and expertise needed to understand the extent and implications of those requirements. In addition, boards must ensure that key staff are properly trained in ESG matters.

Beyond their impact on requisite professional competences, ESG requirements also influence the personal qualities expected of board members, particularly in terms of diversity.

From a Luxembourg law perspective, diversity in the board room is generally considered a key component of good governance for regulated entities. For example, according to Article 38-2(8) of the law of 5 April 1993 on the financial sector, as amended (LFS), credit institutions must engage a broad set of qualities and competences when recruiting members to the management body and for that purpose shall put in place a policy promoting diversity on the management body. The amended CSSF Circular Letter 12/552 on central administration, internal governance and risk management (Circular 12/552) similarly requires banks to include 'aspects of diversity' in the procedures that govern the composition of their management bodies. Here the concept of diversity refers to 'the characteristics of the members of the management body, including their age, gender, geographical origin and educational and professional background'. Circular 12/552 further specifies that 'the promotion of diversity shall be based on the principle of non-discrimination and on measures ensuring equal opportunities'.[34] In October 2023, the CSSF has in this respect published the outcome of an investigation launched in April 2023 on the level of diversity in the management bodies of banks, in which it has emphasised that it will be focusing on enforcing compliance with the applicable rules, notably by carrying out regular investigations and checks and consequently, issuing sanctions in cases of shortcomings.[35]

The recent CAA Circular Letter 22/15 on the board of directors of insurance and reinsurance undertakings[36] also explicitly refers to the 'principle of diversity of qualities and competences'.

Accordingly, boards must ensure when recruiting that they accumulate a broad set of qualities and competences among their members in order to foster constructive criticism and discussion based on different points of view.

While good governance in general is an eligibility criterion for classification as a sustainable investment, board gender diversity in investee companies is now among the mandatory social principal adverse impact (PAI) indicators imposed under the SFDR.[37]

For listed companies, Recommendation 4.1 of the X Principles specifies that, when appointing board members, companies must include diversity criteria in their considerations, including criteria relating to professional experience, geographical origin and the appropriate representation of genders, beyond general skill-based criteria.

The CSDDD proposal stands out as a pivotal component within the broader landscape of European ESG legislative frameworks, particularly capturing the attention of non-regulated entities in Luxembourg. If the most recent iteration of the CSDDD is confirmed in the ongoing negotiations, it will usher in a new regulatory framework characterised by affirmative responsibilities imposed on companies and their board members. These obligations encompass the proactive identification, mitigation and cessation of any adverse environmental and human rights consequences arising from a company's operations. Failure to adhere to these obligations will not only result in administrative penalties but also expose both in-scope companies and their directors to potential civil liability claims.

ii Regulators

General considerations

The Luxembourg Sustainable Finance Initiative is a not-for-profit association that designs and implements the Luxembourg Sustainable Finance Strategy.[38]

It is charged with raising awareness, promoting and developing sustainable finance initiatives in Luxembourg, and helping regulators and financial market participants improve their practices.

Financial sector

The CSSF is the Luxembourg authority competent to supervise the financial sector. It reports to the Ministry of Finance, and its functioning and powers are governed by the amended Law of 23 December 1998 establishing a financial sector supervisory commission.

The Implementing 2022 Law explicitly confirms that the CSSF is the competent authority in Luxembourg tasked with supervising the proper implementation of the SFDR and the EU Taxonomy in the financial sector. The CSSF has been very active in regulating, enforcing and promoting the sustainable finance framework.

In its 2021 and 2022 annual reports, the CSSF has repeatedly highlighted the role and importance of sustainable finance. The CSSF has further, in April 2023, published the list of its supervisory priorities in the area of sustainable finance for credit institutions, asset managers, investment firms and issuers.[39]

In its September 2022 newsletter, the CSSF highlighted that: 'sustainable finance is a rather complex subject, and its objectives can only be fully reached if investors sufficiently understand the different concepts. It is essential to ensure a high level of trust in the regulatory framework which is being implemented. [. . .] Consequently, sustainable finance will continue to require not only educational efforts and financial education efforts from all stakeholders, but also an interest and questioning from investors.'[40]

The CSSF actively participates in financial education efforts, particularly via Letzfin,[41] a website devoted to making the workings of the financial world accessible to the broader public with simple explanations of technical terms, practical advice and interactive tools.

Many industry associations also support the regulator in this area.

Asset managers

The Association of the Luxembourg Fund Industry (ALFI) has regular meetings with the CSSF to discuss technical matters in the pursuit of better large-scale financial education. The association has also prepared many informative publications accessible either to its members or to the general public, including the SFDR Guidelines for Luxembourg, ALFI Guidelines on sustainability-related precontractual disclosures, ALFI guidance on sustainability-related disclosures and reduced subscription tax for EU Taxonomy-compliant investment funds.

Banks

The CSSF is also in close dialogue with the Luxembourg Bankers Association (ABBL), which has made various efforts to promote ESG, for example by adding a chapter on responsible banking into its Code of Conduct, and by participating in the CSSF survey on Luxembourg household knowledge of sustainable finance referred to in Section II. The ABBL has also participated in organising a webinar to broadcast the outcome of the self-assessment exercise regarding climate-related and environmental risks that the CSSF conducted in 2022 with a sample of credit institutions.

Insurance and reinsurance sector

The roles and responsibilities of the CSSF are mirrored in the insurance sector by the CAA (also under the authority of the Ministry of Finance), whose functioning and powers are governed by the amended law of 7 December 2015 on the insurance sector and which is in charge of supervising compliance with any rules and regulations applicable to insurance undertakings, including those pertaining to sustainability.

As for the CSSF, the Implementing 2022 Law explicitly confirms that the CAA is the Luxembourg authority competent to supervise the proper implementation of the SFDR and the EU Taxonomy in the insurance sector.

In an Information Notice published in August 2022,[42] the CAA emphasised the challenges entailed by the regulatory requirements pertaining to sustainable finance, and specified that its own control measures would be gradually adapted to integrate the verification of compliance with the evolving regulatory landscape. In Information Notices published in January and in October 2023, the CAA welcomed the efforts already undertaken by the insurance industry to integrate climate change risks into the companies' ORSA, but also insisted that there are still additional efforts to be made, the progress of which would be supervised by the CAA.[43] The CAA has also specified in its 2022 Annual Report that control of arrangements set up by insurance and reinsurance undertakings and their intermediaries to comply with the regulatory requirements applicable to sustainable finance has been included on the list of the CAA's supervisory priorities for the year 2023.[44]

Sustainable finance instruments

i Incentives for investment funds

In Luxembourg, investment funds are subject to subscription tax on their total net assets (assets under management) valued on the last day of each quarter.

This subscription tax is reduced for more sustainable funds.

Since 2021, funds that invest in assets related to economic activities qualifying as environmentally sustainable (as defined by the EU Taxonomy – EU Taxonomy-compliant assets) have been eligible for reduced subscription tax, currently levied at 0.05 per cent of net asset value (a right conferred by the Luxembourg law of 19 December 2020 on the state revenue and expenditure budget for 2021, amending the law of 17 December 2010 on undertakings for collective investment, implementing Directive (EU) 2014/91 (the UCITS V Directive) into Luxembourg law).

This reduction depends on the percentage of investment in EU Taxonomy-compliant assets:

1. for a fund investing more than 5 per cent of its net assets in EU Taxonomy-compliant assets, the subscription tax is reduced to 4 basis points on that portion;
2. for a fund investing more than 20 per cent of its net assets in EU Taxonomy-compliant assets, the subscription tax is reduced to 3 basis points on that portion;
3. for a fund investing more than 35 per cent of its net assets in EU Taxonomy-compliant assets, the subscription tax is reduced to 2 basis points on that portion; and
4. for funds investing more than 50 per cent of their net assets in EU Taxonomy-compliant assets, the subscription tax is reduced to 1 basis point on that portion.

ii Incentives for corporates

Luxembourg also provides substantial support for sustainable business incentives in the form of financial aid.

The government adopted the amended law of 15 December 2017 on an aid scheme for environmental protection, implementing Regulation (EU) No. 651/2014,[45] which came into force on 25 December 2017.[46] This aid targets all undertakings and natural persons holding establishment permits in order to encourage them as they pursue sustainability transition. The law covers different types of aid with different objectives: investment aid to enable companies to exceed EU environmental protection standards or improve environmental protection in areas that lack standards, to fund early adjustment to future EU standards, to increase energy efficiency in buildings or fund other energy efficiency measures, to enable high-efficiency cogeneration and promote energy from renewable sources, to remediate contaminated sites, as well as to fund efficient heating and cooling networks, waste recycling and reuse, energy infrastructure and environmental studies.

On 10 May 2022, the government also launched the 'Klimabonus' programme, which helps provide reformed and strengthened financial measures to support the ecological, energy and social transition.

Finally, as mentioned in Section IV, the Luxembourg Green Exchange makes industry best practices for green, social and sustainable securities a mandatory requirement.

The Luxembourg Green Exchange is also the only exchange that requires post-issuance commitments from issuers, including certain reports once the security has been issued and listed.

According to the Review of the implementation of EU environmental policy, Luxembourg is Europe's best performer in terms of resource productivity, meaning the efficiency with which the economy uses material resources to produce wealth.

Sustainable disclosure requirements and taxonomy

Luxembourg's sustainable disclosure requirements derive from the NFRD, the SFDR, the EU Taxonomy and additional sector-specific regulations. The recent entry into force of the CSRD, amending the NFRD, will result in revisions of the Luxembourg law of 19 December 2002 on the Trade and Companies Register and the accounting as well as annual accounts of companies, and of the Luxembourg law of 8 December 1994 on the annual accounts and consolidated accounts of Luxembourg insurance and reinsurance undertakings, which were already amended to implement the NFRD in Luxembourg.

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i The NFRD and CSRD

The NFRD, which came into effect in 2017, applies to public interest entities, such as banks and insurance companies, meeting specific criteria concerning their workforce size, balance sheet and net turnover.

Entities falling under the scope of the NFRD are mandated to include a non-financial statement in their management reports, which evaluates the impact of sustainability issues on their operations and of their activities on their external environment.

The recent entry into force of the CSRD, officially published in the Official Journal of the EU on 16 December 2022, introduces amendments to various established directives and regulations and notably strengthens and enhances sustainability reporting provisions for entities previously subject to the NFRD. These changes expand the range of affected companies, introduce more extensive disclosure requirements, and heighten scrutiny regarding assurance. The primary aim of the CSRD is to empower investors to direct their investments toward sustainable initiatives, integrate sustainability considerations into their risk management practices and promote sustained transparency.

The Luxembourg legislative authorities are currently in the process of drafting a bill to implement the provisions of the CSRD into Luxembourg law.

ii The SFDR

The SFDR, which came into force on 10 March 2021, applies to financial market participants and financial advisers; in Luxembourg, these include asset managers, credit institutions that provide portfolio management or investment advice within the meaning of the MiFID II and insurance undertakings that make available, or advise on, insurance-based investment products within the meaning of the IDD.

The SFDR was issued after it had been observed that the absence of harmonised requirements for sustainability-related disclosures had led to the provision of insufficiently detailed disclosures to end investors.

In this context, the SFDR now requires institutions to make pre contractual and ongoing disclosures to end investors in an effort to reduce the asymmetry of information on the integration of sustainability risks, the consideration of adverse sustainability impacts, the promotion of environmental or social characteristics, and the sustainable status of investments.

The SFDR provides for transparency rules at entity level (e.g., asset managers, banks and insurance undertakings) and at product level (e.g., investments funds, pension products, discretionary portfolio management mandates and insurance-based investment products).

Under the entity rules, institutions' websites must contain information about their policies governing the integration of sustainability risks into their investment decision making process, as well as information on whether they consider principal adverse impacts (if so: how; if not: why not). Their remuneration policies must contain information on how they are consistent with the integration of sustainability risks. These requirements have applied since 10 March 2021.

As for product rules, the SFDR establishes a distinction between three types of financial products, subject to different levels of disclosure requirements:

1. financial products without any particular ESG characteristic or sustainable investment objective (standard products);
2. financial products that promote environmental or social characteristics or a combination of those characteristics (provided that the companies in which the investment is made follow good governance practices) (SFDR Article 8 products); and
3. ones having sustainable investment as their objective, meaning an investment in an economic activity that contributes to an environmental or social objective, provided that such investment does not significantly harm any of the other objectives and the investee company follows good governance practices (SFDR Article 9 products).

The pre-contractual documents of all products, including standard products, must at least disclose how sustainability risks are integrated into the investment decisions of a financial market participant, or the investment (or insurance) advice of a financial adviser. The SFDR further requires disclosure of the results of an assessment of the likely impacts of sustainability risks on the returns of the financial products that financial market participants make available or that financial advisers provide advice on. Moreover, the pre-contractual documents for each financial product must include information on the integration of adverse impacts on sustainability factors.

SFDR Article 8 products and SFDR Article 9 products have even more detailed disclosure requirements for their pre-contractual documents, websites and annual reports.

The Level I rules of the SFDR provided for principles-based transparency rules, but were incomplete. This led to many challenges in their implementation as market participants awaited the regulatory and technical standards meant to provide further guidance (known as the SFDR RTS).

On 6 April 2022, the European Commission finally published the final SFDR RTS, which are designed to provide further guidance on the implementation of the SFDR, as amended by the Taxonomy Regulation.

In February 2021, the EBA, EIOPA and ESMA (collectively referred to as the ESAs) published draft RTS on the required content, methodologies and presentation of information to be disclosed under several SFDR provisions. In October 2021, the ESAs supplemented these with RTS on the additional disclosures under the Taxonomy Regulation. After careful review, the European Commission then decided to bundle all RTS into a single instrument known as the Bundled RTS.

Following this announcement, the market awaited a document from the European Commission with all of the RTS drafted by the ESAs. On 6 April 2022, it finally appeared – in the form of a delegated regulation supplementing SFDR (also known as the SFDR Level II). Though delayed, the SFDR Level II (including the SFDR RTS) was finally set to enter into force on 1 January 2023.

As its title indicates, SFDR Level II provides (in the main body) for key principles and more specific guidance on interpreting the SFDR obligations for SFDR Article 8 products and SFDR Article 9 products. The SFDR Level II also provides for:

1. new rules on website disclosures for SFDR Article 8 and 9 products (main body);
2. indicators of principal adverse impacts and disclosure obligations thereon (Annex 1);
3. pre-contractual templates detailing the content of the disclosures required under the SFDR, including any EU Taxonomy-related information needed for SFDR Articles 8 and 9 products (Annex 2 and Annex 3, respectively); and
4. the periodic reporting disclosure templates for SFDR Article 8 and 9 products (Annex 4 and Annex 5, respectively).

SFDR Level II and, more specifically, the pre-contractual disclosures proved to be challenging to implement across Europe. On 27 July 2022, following the publication of SFDR Level II, the CSSF issued a press release announcing its expectations for filing updated pre-contractual documents and periodic reports.

Managers of financial products were required to have updated their pre-contractual disclosures and inserted these templates by 1 January 2023. Because the CSSF anticipated a high workload reviewing updated documents submitted by Luxembourg fund industry players, it issued guidance to help the process run smoothly.

The CSSF basically gave priority for visa-stamping to documents: (1) with updates reflecting only the sustainability-related disclosure changes required by the SFDR RTS; (2) that are complete and compliant with the SFDR RTS; and (3) that it received by 31 October 2022. For these documents, the CSSF released the visa stamp before 31 December 2022.

Thanks to this exceptional fast-track procedure put in place by the CSSF, the Luxembourg financial industry generally managed to implement the pre-contractual disclosures in due time.

The SFDR data collection exercise launched by the CSSF and mentioned above was an essential element in enabling the CSSF to understand the state of the market with regard to the implementation of the various ESG obligations.

In light of this informed understanding of the market, the CSSF, inter alia, issued on 2 December 2022 a FAQs document on the SFDR.[47] In this document, the CSSF addressed key questions raised by the industry and provided long-awaited clarifications on critical aspects of the SFDR. The FAQ has been updated a few times to tackle more topics and questions over the course of 2023.

The CSSF has also reviewed and published a report on how successfully the SFDR and the EU Taxonomy were implemented by the industry.[48] This CSSF Thematic Review focused on five areas:

1. organisational arrangements of investment fund managers – the CSSF highlighted, inter alia, that alternative investment fund managers and management companies remain entirely responsible for ensuring compliance with the sustainability-related provisions that apply to them, regardless of the potential delegation of any function to third parties;
2. compliance of pre-contractual disclosures – the CSSF specified that fund names, ESG characteristics and sustainable objectives must be detailed in a manner that is accessible, clear and not misleading to allow potential investors to make an informed investment decision. Similar observations were made with regard to website disclosures;
3. compliance of periodic disclosure information – the CSSF further indicated that the annual reports should allow investors to verify whether the *ex post* information is consistent with the commitments set out in the pre-contractual disclosures; and
4. fund documentation and marketing communications – the CSSF also stressed that marketing communications must be consistent with any information disclosed under the SFDR; and
5. portfolio analysis – the CSSF confirmed its expectation that managers ensure the ongoing compliance of their portfolio holdings with, for example, potential exclusion clauses in the pre-contractual disclosures.

iii The EU Taxonomy

The EU Taxonomy applies to institutions qualifying as financial market participants under the SFDR, and to institutions in-scope of the NFRD or CSRD.

The EU Taxonomy is a classification tool to help investors and companies make informed investment decisions on environmentally friendly economic activities. Contrary to popular belief, however, it is not a mandatory list to invest in, nor a list of standards or exclusions.

When assessing whether an economic activity can be considered as environmentally sustainable under the EU Taxonomy, the first step is to check whether the EU Taxonomy covers the activity at all.

If the activity is eligible under the EU Taxonomy criteria, the next step is to assess whether it is being performed in a manner that meets the EU Taxonomy's technical screening criteria, which take the form of scientific and technical thresholds. If the economic activity does not meet relevant thresholds or the data needed to establish this cannot be obtained, the activity cannot be considered EU Taxonomy-aligned.

If these first two steps are successful, the next step is to verify that, when making a substantial contribution to one of the EU Taxonomy objectives, the economic activity does not significantly harm any of the other objectives. Here again, the EU Taxonomy provides technical criteria against which the performance of the activity must be checked.

Finally, it must additionally be ensured that the company itself respects minimum social and governance safeguards; for instance, by complying with, inter alia, international agreements on human rights and International Labour Organization labour conditions.

Financial products subject to the SFDR must therefore add specific EU Taxonomy-related disclosures to their pre-contractual information as follows:

1. SFDR standard products must add a specific disclaimer stating that they are not aligned with the EU Taxonomy;
2. SFDR Article 9 products that invest in a sector contributing to environmental objectives are required to disclose which environmental objectives they contribute to, and how and to what extent their investments qualify as environmentally sustainable (including the percentage of their investments that are aligned with the EU Taxonomy); and
3. SFDR Article 8 products promoting environmental characteristics must comply with the same obligations as SFDR Article 9 products while also having a specific disclaimer included.

The transparency rules for entities subject to the SFDR apply in two stages: 1 January 2022 for disclosing information concerning the first two EU Taxonomy objectives, and 1 January 2024[49] for the remaining four objectives. At the same time, while non-financial undertakings in scope of the EU Taxonomy must begin disclosing on their EU-Taxonomy alignment in 2023, financial undertakings only need to begin in 2024.

The above discrepancy in reporting timelines has led to a significant difficulty in sourcing and reporting on data for the purposes of the EU Taxonomy. While especially prevalent in 2022, 2023 has seen a significant improvement in the availability of such information. This is reflected in the fact that 63 per cent of companies on the STOXX Europe 600 have so far reported EU Taxonomy data in 2023.[50]

Moreover, with the entry into force of the CSRD extending the scope of the disclosure rules, the EU Taxonomy now also concerns players other than financial market participants and financial advisers, impacting both large and smaller (non-regulated and unlisted) industrial companies as well.

iv Sector-specific regulations

In addition to the three more general texts discussed above, sector-specific regulations like the CRR and the Solvency II Directive now also include sustainability-related disclosure obligations for banks and insurance undertakings.

The CRR requires large credit institutions[51] whose shares are admitted to trading on a regulated market to disclose prudential information on ESG risks, including transition risks and physical risks, in their Pillar 3 disclosures.

These disclosure requirements were detailed further in draft implementing technical standards (ITS)[52] published by the EBA on 24 January 2022. The ITS set out templates for comparable quantitative disclosures on climate change-related transition and physical risks, including information on exposures towards carbon-related assets and assets subject to chronic and acute climate change events as well as institutions' mitigating actions to support their counterparties in transitioning to a carbon-neutral economy and adapting to climate change; and key performance indicators on institutions' asset financing activities that are environmentally sustainable according to the EU Taxonomy. The ITS also include tables for providing qualitative information on how institutions are embedding ESG considerations in their governance, business model, strategy and risk management framework.

In the insurance sector, ESG risks have not yet been included in the Pillar 3 disclosures imposed under the Solvency II Directive. The EIOPA has, however, indicated that further consideration should be given to mandatory requirements for public disclosures on sustainability risks on both sides of the balance sheet.[53]

In addition, Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing the Solvency II Directive has now been updated to require insurance undertakings of any size to disclose, in their remuneration policies, information on how they consider integrating sustainability risks in their risk management system.

Banks and insurance undertakings now face a deluge of disclosure requirements with diverging scopes and timelines for application.

The first challenge that undertakings must tackle, therefore, is to determine whether, and when, the various requirements may be applicable to them, before embarking on the herculean task of adapting their internal policies and procedures, updating their pre-contractual documentation and periodic reporting and reviewing and expanding the content of their websites.

ESG data, ratings and reporting

The sustainable finance reporting requirements applicable in Luxembourg mainly stem from the EU-level rules in this area; Luxembourg does not have its own specific regime governing ESG data reporting.

Central to the EU rules on ESG reporting are obligations on relevant institutions to add SFDR and EU Taxonomy-related information to their annual reports.

These reporting obligations primarily require institutions to report on how they attained the ESG characteristics or sustainable investment objectives advertised (whatever they may be) over the past reference period.

In addition, institutions are asked to calculate and disclose their level of alignment with the EU Taxonomy.

It may also be necessary to report on certain specific ESG indicators listed in Annex I of the SFDR RTS (namely PAI indicators). This ESG reporting may be done using the templates provided in the Annexes to the SFDR RTS.

Luxembourg has also seen a significant uptake in the FinDatEx European ESG Template (EET) initiative. Many financial market participants in Luxembourg are planning to use the EET to streamline their processing and analysis of investment funds' ESG credentials, notably in order to match them with the ESG preferences expressed by investors in the MiFID II suitability assessments on sustainability. This is leading many investment fund managers to prepare their ESG reporting as EET Excel spreadsheets.

Beyond the general EU-level rules, the laws implementing the NFRD into Luxembourg law (such as the aforementioned law of 19 December 2002) impose an obligation on certain large companies to publish an annual management report with information on ESG topics (e.g., diversity, environment, social questions, respect for human rights and the fight against corruption). In addition, two further factors are leading Luxembourg enterprises to already begin collecting ESG-related data and setting up disclosure procedures. The first is the application of the CSRD, which will impact many Luxembourg entities given that Luxembourg is a popular choice of headquarters for large holding companies. The second is the domino effect that the disclosure obligations on financial market players have on underlying investments: companies' ability to report on their externalities and potential adverse impacts can influence the likelihood of their being granted access to debt or equity financing, or both.

As for companies with shares listed on the Luxembourg Stock Exchange, under Recommendation 9.2 of the Exchange's X Principles, these companies must disclose CSR information either in a separate report or in their management report, in a specific section or in an appendix concerning sustainable development. They must analyse the sustainability of their activities and provide clear and transparent non-financial information to support this analysis. In doing so, companies are advised to rely on well-established international standards and show, in the form of a scoreboard, the CSR performance indicators applicable to their business activities; for example, gender balance, subcontracting and relations with suppliers, energy consumption, water consumption, waste treatment, CO-*2* emissions, adaptation to the consequences of climate change and measures taken to preserve or develop biodiversity.

Sustainable finance incentives

The Luxembourg legislation governing sustainable bond issuance allows bonds to be issued in a variety of forms by various types of companies. Bonds may take a registered, bearer or dematerialised form and, in accordance with Luxembourg private international law, a Luxembourg-based company may issue them subject to Luxembourg law or a foreign law.

Three bond listing platforms are available in Luxembourg:

1. the Securities Official List, a listing venue that does not permit trading but that does give issuers some visibility;
2. the EuroMTF, a multilateral trading facility offering both listing and trading opportunities; and
3. the regulated market, for which bonds require a prospectus compliant with Regulation (EU) 2017/1129.

There is currently no specific mandatory legal regime governing sustainable bonds, and all eyes are on the 2021 Commission proposal for a European green bond standard. This proposal was undergoing intense negotiations, as indicated by the rapporteur's report published in May 2022, which suggests that the framework created by the European green bond standard will be relatively binding. After years of negotiation, a political agreement has been reached on the text of the proposal, where the European Parliament on 5 October 2023 adopted the European Green Bond Regulation introducing the new voluntary EU Green Bond Standards for the use of a 'European Green Bond' label, which currently awaits approval by the Council before its publication in the Official Journal of the EU.[54]

In parallel, Luxembourg market players adhere to the set of principles published by the International Capital Market Association (ICMA) while taking into consideration the EU Taxonomy and the draft rules on the European green bond standard.

Currently, bonds can also benefit from the green bond label issued by LuxFLAG, an independent non-profit Luxembourg association created in July 2006 by ALFI, the ABBL, the European Investment Bank, Luxembourg For Finance, the ADA and the Luxembourg government.

To access the Luxembourg Green Exchange, the Luxembourg Stock Exchange requires issuers to provide an external review of the bond issue performed by a third party and commit to post-issuance reporting. These reports, which are publicly accessible, give a precise insight into the types of projects funded with the issuance proceeds.

For the Luxembourg sustainability bond, these reports indicate that, of a total of €1.1 billion, 53 per cent went to fund social projects, with the remaining 47 per cent allocated to green projects – notably the construction of the Luxembourg tramway, used free of charge by nearly 15 million passengers, resulting in the avoidance of 194,490 tonnes of CO2 emissions.[55]

Carbon markets and carbon trading

Back in 2005, the European legislator created the EU Emissions Trading System (the EU ETS), a mechanism to encourage a reduction in greenhouse gas emissions by the sectors most responsible for emissions, such as airlines, manufacturing and transportation. One of the key pillars of this legislation has been the creation of an exchange so that market players can either sell or buy carbon quotas depending on their activities. In this context, the amended Commission Delegated Regulation (EU) 2019/1122 of 12 March 2019 supplementing Directive 2003/87/EC of the European Parliament and of the Council as regards the functioning of the Union Registry (the Union Registry Regulation) allows participants in the EU ETS to open and hold trading accounts on which can be held general allowances and aviation allowances.

As in many other European jurisdictions, the carbon markets have enjoyed much interest from investment fund managers since early 2022. This has led to the creation of investment vehicles structured with the objective of investing in carbon offsets (verified emissions reductions). This in turn has impacted the whole fund industry value chain; for example, in compelling depositaries and fund administrators in Luxembourg to update their procedures and operational processes to account for the particular features of this new type of asset.

In parallel, financial market participants are looking for ways to gain exposure to carbon markets in traditional UCITS strategies. To achieve this, some are starting to look at the potential UCITS-eligibility of EU emissions allowances (carbon emissions allowances exchangeable under the European Union Emissions Trading Scheme).

Moreover, further to the entry into force of the Union Registry Regulation, the Luxembourg legislator has adopted the law of 15 December 2020 on climate, as amended (the Luxembourg Climate Law), which provides additional conditions with respect to the opening of a trading account in Luxembourg. For instance, based on the Union Registry Regulation, an entity willing to open a trading account shall appoint authorised representatives responsible for initiating transactions in respect of quotas to be held in the trading account. The Luxembourg Climate Law requires that one of these authorised representatives be a Luxembourg resident.

It is worth noting that the creation of the first ever pledge over emission allowances held in a trading account at EU level occurred in Luxembourg. The creation of such a security interest was possible because of the provisions of the Luxembourg law of 2005 on financial collateral arrangements, which enables the creation of pledges over financial instruments and the Luxembourg law of 5 April 1993 on the financial sector, which classifies emission allowances as financial instruments.

More recently, on 5 October 2023, Bill of Law No. 8320 amending the Luxembourg Climate Law was published. The purpose of this piece of legislation is to implement into national legislation no less than two European directives and two European regulations. Most of the provisions of the Bill of Law aim to enact more stringent rules on carbon quotas, whether for airlines, transportation by road or the construction sector. On top of that, Luxembourg is considering restricting the conditions to open a trading account to prevent fraud, but at this stage, it is uncertain whether this restriction will be implemented.

Green technology

Technology is a key pillar of the transition to a green economy, and Luxembourg has a central role and strong involvement in the development of green technologies.[56]

First and foremost, thanks to the presence of the European Investment Bank and investment funds specialising in renewable energies and energy efficiency, Luxembourg, as the second largest centre for investment funds worldwide, is de facto a global hub for financing green technologies.

In addition, market players know that sustainable finance requires a high degree of transparency between investors and investment funds. Therefore, this requires reliance on technology to monitor a large amount of data to achieve the expected standard of transparency. It must be mentioned here, with regard to this challenging task, that the CSSF was the first European regulator to adopt a clear legal position on virtual currencies, leading to the licensing of two major crypto exchanges as payment institutions in 2016 and 2017. Furthermore, in 2019, Parliament passed a law on the use of distributed ledger technology for the circulation of securities, which has been amended recently to take into account new developments.[57] As highlighted by the ABBL, distributed ledger technology ensures transparency for investors and allows them to monitor whether their projects reach their targets, introducing new ways of accessing information, even though the advantages of using DLT must be assessed in light of its impact on the environment.

Lastly, the Luxembourg government launched landmark initiatives such as the creation of the Luxembourg House of Financial Technology (LHoFT), which together with Luxembourg's Directorate for Development Cooperation and Humanitarian Affairs and the European Investment Bank, holds a regular programme to support the emergence and development of inclusive finance fintech solutions.[58]

Climate change, nature and biodiversity impacts

As mentioned in Section II, key regulatory initiatives linked to climate change mitigation in Luxembourg's banking sector include the adoption of specific regulatory requirements to integrate ESG risks, and especially climate change risks, into banks' overall business strategies, risk management frameworks and governance requirements.

CSSF Circular Letter 21/773 on the management of climate-related and environmental risks requires institutions to integrate ESG risks into their business strategies, risk management frameworks and governance arrangements. It applies to all credit institutions deemed less significant institutions under the Single Supervisory Mechanism, and to all branches of non-EU credit institutions, and is consistent with the European Central Bank's Guide on climate-related and environmental risks and the Guide for Supervisors: integrating climate-related and environmental risks into prudential supervision published by the Network of Central Banks and Supervisors for Greening the Financial System.

These requirements are mirrored in Circular 12/552, which also specifies that a bank's business model, internal governance arrangements and risk management framework should take into account all risks and relevant risk factors, including ESG risks.

In 2023, the CSSF has been actively verifying compliance with the aforementioned requirements via the self-assessment related to CSSF Circular Letter 21/773 on climate-related and environmental risks.[59]

In the insurance sector, climate change risks were specifically addressed in the application guidance on running climate change materiality assessments and using climate change scenarios in the own risk and solvency assessment (ORSA)[60] published by the EIOPA in August 2022[61] and in CAA Information Notices 23/2 and 23/9 on the (follow-up on) the implementation of scenarios linked to climate change risks in the ORSA.[62]

According to CAA Information Notice 22/9 regarding the regulatory challenges linked to sustainable finance, the main challenges for concerned undertakings will consist in analysing the impacts of climate change on their activity and conducting specific stress tests as part of their forward-looking ORSA assessments, which may require actuarial projection models (and therefore special technical expertise).

By and large, the applicable regulatory frameworks for ESG risk management are fairly recent creations, making it difficult to assess how 'successful' they are at this stage. Monitoring this success will be one of the key tasks of the competent supervisory authorities.

Greenwashing and climate litigation risks

An additional challenge that market players are now increasingly facing is a growing risk of litigation.

There is a large and growing number of climate litigation cases, based on a large variety of claims. Most companies are criticised for disclosing sustainability statements that are not aligned with reality. These behaviours are generally labelled 'greenwashing', for which, in the regulated world, the three ESAs have now proposed a common definition: 'a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services'.

However, companies are also criticised because of other behaviours, such as the failure to achieve disclosed ESG commitments, the use of ambiguous wording in ESG disclosures and the failure to make sufficiently ambitious ESG commitments.

These litigation cases are often initiated by 'activist shareholders', who acquire a minority stake in a company in order to launch a lawsuit against the company and sometimes also its directors individually, and to use these lawsuits as a means of putting pressure on politicians and decision-makers to impose binding changes in corporate strategies.

While there has not been any specific ESG-related litigation case in Luxembourg so far, there is a risk that claimants may now try to rely on allegedly defective ESG publications or commitments to claim damages from the disclosing entity. An unhappy investor who has suffered losses in their investment portfolio could hence be tempted to sue the issuers or manufacturers of the financial instruments included in the portfolio for inadequate disclosures on the ESG features of the relevant instruments, to be indemnified for such losses.

To succeed in such a claim, the relevant investor must, however, prove that the inadequate ESG disclosure was the direct and natural cause of the loss suffered by the portfolio, which may be very difficult, as financial losses are often mainly due to other causes, such as market risk or bad portfolio management decisions.

In addition, the inadequate ESG disclosure must qualify as a wrongful act, which is not necessarily always the case, for two reasons. First, the lack of any uniform globally accepted definition of what is 'sustainable' makes it very difficult to clearly define the kind of behaviour that should be considered as faulty when describing a given product as 'sustainable'. The debate about the sustainable or unsustainable nature of gas and nuclear energy for the purposes of EU Taxonomy eligibility provides an example of the fact that, what may be considered 'green', is still not univocally clear. Second, many inadequate disclosures are the result of a struggle to understand the exact extent and content of the complex applicable disclosure obligations or of a lack of correct, complete and consistent data upon which the relevant disclosures are relying. Many misrepresentations are thus unintentional and committed by companies who, in good faith, wish to be accurate in their ESG disclosures.

In addition, regulated entities must contend with their supervisory authorities, who are now concentrating more strongly on compliance with sustainability-related rules and obligations.

In the asset management industry, the CSSF has recently reviewed and published a report on the success of implementing the sustainability-related provisions introduced by key European sustainable finance regulations, such as the SFDR and the Taxonomy Regulation.[63]

More generally, in April 2023, the CSSF published a list of specific supervisory focus areas regarding ESG matters for credit institutions, asset managers, investment firms and issuers and specified that it expects board members to ensure the proper integration of ESG factors into the governance, risk management, compliance and training arrangements of their institutions.[64]

In the insurance sector, the CAA has similarly specified, in its 2022 Annual Report, that control of arrangements set up by insurance and reinsurance undertakings and their intermediaries to comply with the regulatory requirements applicable to sustainable finance has been included on the list of the CAA's supervisory priorities for 2023.[65]

Outlook and conclusions

Beyond the broader future developments that the SFDR, the NFRD, the CSRD, the EU Taxonomy and the draft CSDDD have set in motion, there are several major hurdles that Luxembourg banking and insurance market actors will have to surmount sooner rather than later.

Banks will first have to comply with the detailed product governance requirements imposed under the GDR 2022, which became applicable on 22 November 2022.

Banks will further have to consider the rules included in ESMA's Final Report – Guidelines on certain aspects of the MiFID II suitability requirements, published on 23 September 2022 (the ESMA Suitability Guidelines)[66] and the rules of the Final Report – Guidelines on MiFID II product governance requirements, published on 23 March 2023 (the ESMA Product Governance Guidelines).[67] The ESMA Suitability Guidelines integrate sustainability factors, risks and preferences into certain organisational requirements and operating conditions imposed under MiFID II, while the ESMA Product Governance Guidelines have been updated to require, in particular, the specification of any sustainability-related objectives with which a product is compatible. As a follow-up to these updated guidelines, in 2024, ESMA will launch a common supervisory action (CSA) with national competent authorities (NCAs) on the integration of sustainability in firms' suitability assessments and product governance processes and procedures. The goal of the CSA will be to assess the progress made by professionals in the application of the key sustainability requirements that entered into application in 2022 and cover: (1) how firms collect information on their clients' sustainability preferences; (2) which arrangements firms have put in place to understand and correctly categorise investment products with sustainability factors for the purpose of the suitability assessment; (3) how firms ensure the suitability of an investment with respect to sustainability; and (4) how firms specify any sustainability-related objectives a product is compatible with as part of the target market assessment of the investment product.

Finally, major future developments could potentially derive from the outcome of a discussion paper on the role of environmental risks in the prudential framework[68] launched by ESMA in May 2022, in which it explores whether and how environmental risks are to be incorporated into the Pillar 1 prudential framework imposed under the CRR. In the paper, ESMA discusses targeted enhancements and clarifications within the existing framework that would be needed to address environmental risks, and the potential incorporation of forward-looking methodologies as an alternative to introducing specific risk-weighted adjustment factors. In this context, a provisional agreement was reached on 27 June 2023 on amendments to the CRR and the CRD, which notably also include changes to enhance banks' management of ESG risks.

On the insurance side, EIOPA states in its guidance on the integration of sustainability preferences in suitability assessments under the IDD published in July 2022 (the EIOPA suitability guidance) that, unlike ESMA, it has paused its work on issuing formal guidelines in this area. For the time being, therefore, concerned insurance undertakings will have to make do with the practical recommendations contained in the EIOPA suitability guidance.

With respect to potential developments in the prudential framework, European institutions are currently discussing the proposal for a directive amending the Solvency II Directive published by the Commission in September 2021,[69] which mandates the EIOPA to explore a specific prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives, and to regularly review the scope and calibration of the standard formula pertaining to natural disaster risks. The outcome of such a proposal may thus have major impacts on the insurance industry.

In this environment, even Luxembourg's non-financial industry players must continue to adapt their business models to more sound and transparent governance, if they are to maintain access to external financing, mitigate the medium and long-term risks of unsustainability and limit the transitional risks caused by the fluctuating EU legislative backdrop (especially the new rules set forth in the CSRD and the draft CSDDD, and the broad-based disruptions these will bring to unregulated enterprises). Said non-financial industry players are currently engaged in a proactive process of comparing their reporting practices and corporate policies with those of their counterparts and peers. These initiatives are driven by the impending changes, as, inter alia, the first reporting period for the CSRD is swiftly approaching, commencing as early as 1 January 2024, for companies that were already subject to the NFRD.

One of the key market challenges that Luxembourg financial actors are facing in relation to sustainability is implementing the existing requirements that are currently being integrated into the regulators' supervisory processes and practices, and remaining agile enough to adapt to the additional sustainability-related legislative changes that are expected to come into force in the future.

Endnotes

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Introduction

Sustainable finance in Mexico is witnessing a transformative evolution. Historically, the nation's commitment to sustainability was anchored in its adherence to global mandates, such as the Equator Principles, the standards of the International Finance Corporation and the guidelines from the Inter-American Development Bank. These global standards underscored the nation's commitment to environmental stewardship and social responsibility in financial dealings. Yet, standards were inconsistently applied, leaving gaps, especially in corporate loans.

The current landscape, however, has been consistently shifting. Innovative financial instruments, notably green, social and sustainability-linked bonds, are rapidly gaining traction. The Financial Stability Report from the Mexican Central Bank (Banxico) highlights this transition, indicating an impressive 267 billion pesos in environmental, social and governance (ESG) bond issuances since 2016.[2]

This movement is not just a fleeting trend. It is spurred by heightened investor awareness, the global climate imperative and a renewed corporate understanding of broader societal obligations. Leading businesses now recognise that embracing ESG practices is not merely about compliance or corporate responsibility – it is a strategy that enhances operational efficiency, mitigates risks and fortifies stakeholder trust. Firms such as BlackRock Mexico advocate for this narrative, spotlighting the multifaceted advantages of embedding ESG principles into corporate frameworks.

Furthermore, the Mexican Sustainable Finance Mobilisation Strategy is a testament to the country's proactive approach to advocating for green financing. Designed to align Mexico with global imperatives, this strategy not only emphasises the importance of sustainable financing but also aims to pave the way for its implementation on home ground.

Alongside this, the Mexican Sustainable Taxonomy[3] has been introduced, establishing a framework that defines what qualifies as 'green' and 'sustainable'. This taxonomy provides benchmarks and definitions to validate the authenticity of green investments, offering a proactive measure against mischaracterisations and ensuring that investors understand the true nature of their green investments.

While ESG reporting in Mexico remains primarily voluntary, there are exceptions with a handful of mandatory sustainable disclosure requirements (SDRs) as outlined in Section V, albeit minimal. Nonetheless, the drive for transformation is unmistakable. The introduction of the FTSE4 Good BIVA Index and the S&P/BMV Total Mexico ESG Index, along with an array of initiatives from the private sector, signal a promising and more transparent future for sustainable finance in the country.

As at 2022, the Mexican government documented approximately 138 projects and activities tied to carbon markets. Despite these hurdles, public entities, such as the Ministry of Finance and Public Credit, have highlighted the importance of setting clear targets and enacted sustainable finance mobilisation strategies.

Year in review

2022 was a landmark year for sustainable finance in Mexico, marked by a record 267 billion Mexican pesos in thematic bond issuances. This was not merely a surge in market confidence; it signified Mexico's growing allegiance to ESG principles.

In this dynamic context, traditional instruments such as green, social and sustainability bonds, recognised as such by The International Capital Market Association (ICMA), gained significant ground. This success heralded the entry of innovative solutions such as blue-themed bonds and sovereign sustainable bonds, demonstrating a readiness in public and private sectors to diversify investments with a keen eye on sustainability.

The Climate Bonds Initiative (CBI) has recognised Mexico as the world's fifth-largest sustainable bond issuer. Predictions suggest that thematic bonds might represent half of all debt placements in Mexico's capital market by the year's end, indicating a solid interest in ESG-compliant investments and a maturing market understanding of their enduring benefits.

The regulatory landscape also evolved to support ESG investments. In September 2022, the National Commission of the Retirement Savings System (CONSAR) enacted crucial amendments, embedding ESG criteria into its general provisions, a significant shift for Mexico's retirement savings system. This overhaul included risk management policies for Investment Funds Specialized in Retirement Funds (SIEFORES), the inclusion of ESG risk assessments in investment committees and compulsory ESG training and certification for officials, acknowledging the critical role of ESG in mitigating long-term investment risks.

2023 maintained this momentum, with the introduction of the Mexican Sustainable Taxonomy in March. This pivotal initiative aims to standardise sustainable economic activities, drive investment towards projects aligning with national and international environmental, social goals. It is a clear, legitimate, and science-backed classification system, enhancing transparency and reducing greenwashing. Although the Taxonomy does not enforce penalties for non-compliance, it is influential in standardising sustainability criteria, informing investment choices and shaping market conduct.

The Sustainable Finance Mobilization Strategy, introduced in September 2023, further solidified Mexico's dedication to sustainable finance. This comprehensive plan, established after the Sustainable Taxonomy, underscores Mexico's dedication to infusing sustainability throughout its financial systems. It sets forth specific actions for public financial management, the mobilisation of sustainable finance and a strong emphasis on gender equality, acting as a catalyst for cross-sectoral change. The upcoming public consultation process highlights the government's commitment to inclusivity, seeking diverse viewpoints to sculpt a robust, equitable sustainable finance framework.

In summary, the progress in 2022 and early 2023 signals a foundational shift in investment strategies, aligning financial mechanisms with sustainable development imperatives. The burgeoning sustainable finance market in Mexico, buoyed by ESG considerations, opens vast opportunities for innovation in financial instruments and strengthens regulatory frameworks, paving the way for a sustainable economic future.

Regulation and policy

i Governance regime

In Mexico, a definitive and robust legal framework dedicated exclusively to sustainable financing has yet to be established. Nonetheless, as detailed throughout this chapter, environmental policy has significantly evolved via key legislation and initiatives.

The General Law on Climate Change (GLCC) is the principal statute and establishes the provisions to address the adverse effects of climate change, and regulate the environmental protection, sustainable development, preservation and restoration of ecological balance provisions set forth in the Constitution, setting forth ambitious emission reduction targets: a 50 per cent decrease by 2050 compared to 2000 levels, alongside specified reductions by 2030, namely 22 per cent for greenhouse gases and 51 per cent for black carbon. This legislation underscores the necessity to decouple economic growth from increases in emissions.

In addition, the General Law of Ecological Balance and Environmental Protection offers a voluntary mechanism for businesses to self-regulate, aiming to surpass fundamental environmental standards. The provisions of this policy are of public order and social interest and aim to promote sustainable development and indicate a move towards a regulatory landscape bolstered by initiatives promoting corporate environmental responsibility.

Advancements in incorporating environmental, social and governance (ESG) considerations into investment decisions are marked by the National Commission of the Retirement Savings System (CONSAR)'s 2022 amendments, which embed ESG criteria into the workings of pension funds – a significant step for Mexico's financial sector.

Although there are no specific regulations for ESG reporting, this responsibility can be inferred as part of the fiduciary duty of diligence and care set forth in the General Law of Commercial Companies considering that directors must publish an annual financial report to shareholders that includes information describing the company's financial status, to the extent that climate change risks are important to the activity and purpose for a company. Mexican companies tend to align with international reporting standards such as the Global Reporting Initiative (GRI), propelled by global expectations and investor demand. Adherence to these standards is manifested in the mandatory disclosures to the National Banking and Securities Commission, as per the General Provisions Applicable to Securities Issuers, underscoring Mexico's engagement with international financial practices.

ii Regulators

The nation's policy framework is influenced by both domestic legislation and international treaties. The Special Climate Change Programme (PECC) and the National Climate Change Strategy (ENCC), deriving from the GLCC, outline a systematic approach to address climate change. The National Development Plan, underpinned by the nation's constitution, weaves sustainable development into its fabric and addresses Sustainable Development Goals (SDGs), demonstrating the government's allegiance to international targets.

Additionally, with the formation of the Mexican Sustainable Finance Mobilisation Strategy and the establishment of a Mexican Sustainable Taxonomy, Mexico is refining its approach and directives for sustainable investment.

Corporate entities such as the Federal Electricity Commission are progressing towards international ESG standards, exemplified by their collaboration with the World Bank's MIGA for renewable energy projects, ensuring adherence to global norms.

In Mexico greenwashing is sanctioned by the existing consumer protection and financial laws that mandate truthful representation of environmental benefits and sustainability practices. The Federal Consumer Protection Law, the provisions by the National Commission for the Protection and Defence of Users of Financial Services, and the Securities Market Law act as a bulwark against deceptive environmental assertions.

Mexico's composite governance regime, despite its challenges and the need for more enforceable legislation, signifies a concerted endeavour to embed sustainability within the realm of finance, guided by a blend of legal mandates and the pursuit of international benchmarks.

Sustainable finance instruments

The Mexican legal system accommodates contemporary sustainable financing instruments, such as sustainability-linked loans and bonds, thematic bonds and social venture capital. Although there is no specific legal framework for sustainable finance products, this flexibility is crucial as the market evolves. The lack of a dedicated framework has not impeded the adoption of international sustainable finance tools by both private and public issuers.

Sustainable financing in Mexico aims to allocate resources to projects focused on climate transition, conservation, and adaptation. Recent sustainability-linked bonds in Mexico have established KPIs aimed at enhancing diversity, inclusivity and commitment to transition goals within business plans.

Legislative changes have encouraged leading institutional investors, including managers of retirement funds (AFOREs), to pursue ESG investments, stimulating the market and creating a project pipeline. Significant public policies, such as the National Development Plan 2019–2024 and the National Climate Change Strategy (ENCC), complement private companies' ESG-themed issuances in the capital market.[4]

Significant thematic bond issuances this year in Mexican markets include: (1) Fibra Danhos, a leading Mexican public REIT focused on the development, redevelopment, acquisition and management of premier shopping centres, offices and mixed-use projects in Mexico, issued their sustainability-linked bonds for 2,500 million pesos with KPIs geared towards enhancing the sustainability of their portfolio and making their board more diverse; (2) FIRA, dedicated to supporting Mexico's rural, agricultural, forestry and fishing sectors, launched its first gender focused bond, aimed at promoting the economic independence of women and valued at 3,000 million pesos; and (3) OMA, a company experienced in airport management and operations in Mexico, issued its sustainability-linked bonds totalling 640 million pesos and 2,560 million pesos, respectively.

While many public and private companies adhere to international guidelines, significant national initiatives have emerged from private associations to standardise the drafting of disclosure, reporting guidelines and metrics for public companies. A notable example is the guidelines published by the Mexican Association of Real Estate FIBRAs (AMEFIBRA), which apply to a diverse range of Mexican REITs.

Efforts to implement standardised drafting also include AFOREs, both on an individual basis and collectively through their national association, and AMAFORE to facilitate investments.[5] For instance, several AFOREs adopted standard ESG clauses concerning: (1) responsible investment principles and ESG criteria; (2) ongoing communication and information-sharing during agreements; (3) measures to address defaults; and (4) the Task Force on Climate-related Financial Disclosures (TCFD) and climate scenario analysis.[6]

Furthermore, Mexican law firms such as Nader, Hayaux & Goebel and Hogan Lovells BSTL are collaborating with innovative initiatives such as The Chancery Lane Project – an international coalition of lawyers and business leaders aimed at promoting decarbonisation using public model environmental clauses in various jurisdictions – in the transposition of their standard clauses to introduce them to the Mexican market.

Mexican secondary markets are also actively incorporating ESG criteria. The Mexican Derivatives Exchange (MexDer) and Mexder's Clearing House, referred to as 'Asigna', have committed to allocating a portion of operational revenues through its Green Finance Advisory Council. This allocation supports the promotion and financing of projects with beneficial impacts on both the environment and broader society.[7]

Sustainable disclosure requirements and taxonomy

In Mexico, mandatory sustainable disclosure requirements (SDRs) are notably limited, and, currently, they are encapsulated within regulations pertinent to a highly specific sector of the economy.

Under the General Provisions Applicable to Securities Issuers and other Participants of the Stock Market, public companies in Mexico are obliged to disclose the following information in the annual reports submitted to the National Banking and Securities Commission:

1. a description of the factors potentially impacting its operational performance and profitability, encompassing environmental concerns that could influence its assets, products, and services, alterations in the relevant environmental regulation and international environmental treaties; and
2. a description of its business activities providing adequate information for prospective investors, comprising environmental performance, current environmental policies or management systems, recognition through environmental certificates or awards and initiatives for environmental protection or restoration. In addition, the company is mandated to elucidate if any of its undertakings poses a significant environmental threat and mandated to reveal both existing and prospective implications of climate change on its operations.

Currently, approximately 54 per cent of the top 100 revenue-generating Mexican companies disclose sustainability information in their annual financial reports (remarkably, even PEMEX, the state-owned oil enterprise, integrated ESG principles into its 2023–2027 Business Plan).[8] However, a substantial portion of this data is disclosed as a narrative, rather than with a quantitative focus, partly as a consequence of the absence of standardised criteria for effectively assessing adherence to the SDRs.

Pertinently, Mexico has recently witnessed a surge in initiatives aimed at compelling corporate entities to not only disclose sustainability-related information but also to enhance the quality, reliability and comparability of this data.

In March 2023, the Ministry of Finance and Public Credit unveiled the Mexican Sustainable Taxonomy, devised collaboratively by experts from both public and private sectors, marking it as the inaugural global taxonomy encompassing environmental and social dimensions. As per HR Ratings, this taxonomy eradicates a primary barrier within the Mexican market, potentially fostering investment in sustainable ventures and augmenting transparency in labelled financing. The Taxonomy's introduction signifies the commencement of a phased implementation, necessitating comprehensive training for pertinent authorities and the promulgation of associated regulations.

Additionally, in 2021, the Consorcio TCFD México was established, originating from a collaborative endeavour by the financial sector, bolstered by international partnerships, to encourage the assimilation and application of the TCFD's recommendations within Mexico. This consortium functions primarily as an advisory body dedicated to assisting corporations in navigating the nuances of climate financing.

Finally, in 2022 the local chapter of the Climate Governance Initiative was launched in Mexico as Chapter Zero Mexico, promoting the eight Principles of Climate Governance and creating a community of directors committed with climate governance to transition to a net zero economy before 2050.

While the standards promoted by these movements have not been formally integrated into the Mexican legal framework, these concerted actions unequivocally signal Mexico's commitment to align with established market practices and a transition to a net zero economy. This ensures investors can avail themselves of the advantages conferred by sustainable financing instruments, gaining distinct importance in light of nearshoring trends.

ESG data, ratings and reporting

Mexico currently participates in numerous national, international, and bilateral treaties and agreements that establish benchmarks for green and sustainable goals. In 2015, Mexico committed to the 2030 Agenda for Sustainable Development and, in 2016, ratified the Paris Agreement. Currently, Mexican regulations are evolving to encourage a cohesive approach to sustainable financing and development.

Additionally, Mexico is part of regional agreements such as the Regional Agreement on Access to Information, Public Participation and Justice in Environmental Matters in Latin America and the Caribbean. This agreement highlights the necessity for compliance and protection of rights concerning information accessibility, public participation and justice in environmental matters, particularly for government entities and private organisations utilising public funds. Mexico has also ratified the Convention Establishing the Sustainable Tourism Zone of the Caribbean, advocating for tourist destinations that implement best practices for environmental and community protection.

The Mexican General Law on Climate Change (GLOC) lays out the primary legal foundation for public policy direction and actions towards climate transition and mitigation. The GLOC sets an ambitious goal of reducing emissions by 50 per cent by 2050 from the levels reported in 2000, and mandates an unconditional 22 per cent reduction in greenhouse gas emissions and a 51 per cent cut in black carbon emissions by 2030, emphasising the decoupling of greenhouse gas emissions from economic growth.

Other key legislation includes the General Law of Ecological Balance and Environmental Protection (the Mexican Environmental Law), offering businesses voluntary pathways for self-regulation, demonstrating their commitment to exceeding stringent environmental protection standards.

Key public policies influenced by national legislation and international environmental treaties include:

1. the Special Climate Change Programme (PECC), established by the GLOC, outlining objectives, strategies, actions and goals for climate change, defining priorities, responsibilities, coordination, results and cost estimates;
2. the National Climate Change Strategy (ENCC), also initiated by the GLOC, guides national policy towards a sustainable, low-carbon economy;
3. the National Development Plan, rooted in the Constitution of Mexico, outlines national challenges and solutions over six years, integrating sustainable development as a core principle, and emphasising SDGs related to poverty eradication, inequality reduction, decent work and health and wellbeing;
4. the Mexican Sustainable Taxonomy; and
5. the Mexican Sustainable Finance Mobilisation Strategy.

For the private sector, the 2030 Agenda for Sustainable Development represents a significant commitment, seeking balance in economic, social and environmental sustainability, and promoting long-term goals and cooperation among public, private and social sectors. Initiatives such as the United Nations Global Compact, which currently includes 750 companies in Mexico, embody this commitment.[9]

While Mexican law does not mandate ESG reporting, many companies voluntarily integrate ESG principles into their reporting practices, aligning with local and international standards. Moreover, environmental regulations and Official Mexican Standards (NOMs) set strict rules on emissions, waste management, recycling and industry-specific requirements.

Although ESG reporting is not regulated, international pressure and investor expectations encourage adherence to global reporting standards such as the Global Reporting Initiative (GRI), ICMA's guidelines, the European Sustainability Reporting Standards (ESRS) and standards set by the US Securities and Exchange Commission.

External review and verification processes remain optional for issuers and businesses, presenting challenges in standardising reports.

The International Sustainability Standards Board (ISSB) has introduced the International Financial Reporting Standards on Sustainability: IFRS S1 and IFRS S2, focusing on general sustainability-related financial data and climate-specific disclosures, respectively. Global securities regulators and investors are expected to enforce or recommend these Standards. Both the G20 and the International Organization of Securities Commissions

(OICV-IOSCO), with Mexico as a member, endorse the Standards, advocating for their integration into regulatory frameworks.

In Mexico, some sustainability-linked bonds utilise second-party opinions (SPOs) for their KPI goals and achievements, offering extra assurance to investors and contributing to the consistency of ESG data reported by issuers.

Sustainable finance incentives

The Mexican market and legislation do not address sustainable finance incentives.

Carbon markets and carbon trading

The ENCC underscores the significance of carbon markets, drawing attention to models in countries such as Australia, Japan, New Zealand and the United States. It also views carbon markets as a foundational policy pillar and a crucial course of action. The GLOC initiates a forward-looking emissions trading system aimed at fostering emissions reductions at the lowest economic cost. Through this system, prospective participants are anticipated to engage in operations and transactions connected to emissions trading internationally. In 2021, a preliminary version of this emissions trading system was tested. However, a complete and functional progressive emissions trading system remains to be realised.

The journey to establish a fully functional private carbon market has faced challenges in recent times, primarily due to gaps in the GLOC's supplementary regulations and inconsistent communication between the public and private sectors.

Concurrently, the private sector has shown progress in this area. Notable initiatives such as the Mexican Carbon Platform (MEXICO2)[10] is working to connect companies in Mexico and across Latin America with top-tier carbon projects. MEXICO2 currently supports 13 carbon initiatives distributed across Mexico and accredited by international standards.

Green technology

Sustainable financing is still nascent in Mexico. Notably, it was only in 2020 that Mexico issued its first sustainable bond, one specifically tied to the Sustainable Development Goals advocated by the United Nations. As described before, Mexico is laying the groundwork to adopt prevalent sustainable financing instruments that necessitate robust and enforceable sustainability standards. Consequently, it is fair to conclude that, at this juncture, the Mexican finance sector is concentrating on cultivating a spectrum of opportunities to back sustainable ventures broadly, rather than delving into specialised technologies. This focus encompasses options readily accessible to developers within the existing market framework.

Notable endeavours include the formation of the Green Finance Advisory Council, a body emblematic of Mexico's finance sector, dedicated to endorsing the financing of projects and assets with a positive environmental footprint. The Council has put forth initiatives such as the Mexican Green Bonds Principles and the Investors' Declaration in support of Green Bond Financing.

Nacional Financiera, a national development bank, collaborates with international entities, including the Inter-American Development Bank, to extend financing aimed at small and medium-sized enterprises embarking on energy efficiency projects. This focus stems from the recognition that these enterprises hold significant potential in curbing greenhouse gas emissions, alongside fostering a surge in generation capacity derived from geothermal resources.

Additionally, it is crucial to acknowledge that Mexican corporations are in the midst of aligning with, and adhering to, prevailing standards to secure sustainable financing. For instance, the Federal Electricity Commission (CFE) and the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group initiated a collaborative venture to encourage renewable energy projects in Mexico, achieved through the refurbishment and modernisation of hydroelectric power stations. To procure the necessary financing, the CFE complied with ESG principles in line with World Bank standards.

In light of these developments, it is reasonable to anticipate that emerging technologies, such as green hydrogen, will soon be in the crosshairs of such financing, especially given Mexico's potential to evolve into a key global nexus for the production and export of this product.[11]

Climate change, nature and biodiversity impacts

Mexico has an extensive regulatory regime that strives to protect against climate change and protect nature, biodiversity, and human rights. The main objective of the environmental framework is to achieve an integrated, cross-sectoral, decentralised environmental policy with the participation of all sectors of society, based on the principle of sustainable development and the constitutional right to live in a healthy environment. This legislative framework is provided mainly in the Mexican Environmental Law and other sectoral laws.

However, despite ongoing reform efforts made to these laws in recent years, their implementation and enforcement is still not effective for two main reasons. First, the authorities are not enforcing nor fully complying with the regulations. There is little clarity on the responsibilities of the authorities, and there are challenges with infrastructure and institutional organisation. Second, according to the legislative working committee that identifies areas of opportunity in Mexican legislation regarding sustainable development goals, the legislation is still not fully aligned with current environmental challenges. It does not place sustainable development at its core, does not fully integrate relevant scientific and social information and lacks homogeneity in its structure and design.[12]

As a result, Mexico's biodiversity and environment have suffered consequences, such as extreme heat waves, droughts, floods, deforestation and pollution.

According to the Climate Litigation Platform for Latin America and the Caribbean,[13] a total of 18 climate litigation cases have taken place in Mexico since 2013. Most of these lawsuits have been against Mexican regulatory and legislative authorities, mostly in the energy sector, and concern the amendment or enactment of rules contrary to the human right to a healthy environment or to international environmental treaties to which Mexico is a party.

In terms of climate risks, Mexico faces both physical and transition risks. Since Mexico is vulnerable to extreme weather events with severe consequences for its environment and communities, it needs to focus on enforcing and updating existing regulations to integrate sustainable development principles and build resilience against climate threats.

Greenwashing and climate litigation risks

Greenwashing is defined as the act by which companies mislead consumers by promoting unfounded or misleading claims about the environmental and sustainable attributes or benefits of a product or service they offer, or the policies and principles that govern them.

In Mexico, there is no specific law or regulation that directly addresses, restricts or penalises greenwashing. However, broader regulations, such as consumer protection laws and financial regulations, do set guidelines against misleading advertising.

The Federal Consumer Protection Law mandates suppliers to offer accurate, verifiable and clear descriptions and information about their goods, products and services.

The National Commission for the Protection and Defence of Users of Financial Services sets forth general provisions requiring financial entities to operate following sound practices. This includes providing users with information that is not misleading about the services they offer.

The Securities Market Law stipulates that issuers must not disseminate false details regarding the environmental benefits or sustainability of their products, services and policies.

Violating these regulations can lead to penalties. These might be administrative actions, such as temporary or partial business shutdowns, fines and, in some instances, even criminal charges.

To date, Mexico has not seen any climate litigation cases directly associated with greenwashing. This is largely because of the lack of targeted legislation and limited national focus in this domain. Still, given the rising global attention on greenwashing, more and more Mexican businesses are becoming aware of the reputational risks linked to employing deceptive environmental advertising in their operations.

Outlook and conclusions

Peering into the future of sustainable finance in Mexico, there are promising opportunities on the horizon. While large corporate entities and international conglomerates were the early trailblazers of ESG considerations, the broader private sector, propelled by advocacy and support from eminent investment leaders and institutions like AFOREs, is now marching in step.

Mexico's venture into green bonds truly commenced in 2015, driven by the pioneering initiatives of institutions like Nacional Financiera. The enthusiasm and dedication to sustainable finance have climbed steadily, culminating in a notable surge of sustainable bond issuances by 2022. The resilience of this growth, particularly in the face of global challenges such as the covid-19 pandemic, is commendable.

Yet, the path is strewn with obstacles. Many of Mexico's enterprises, especially those outside the realm of large corporations, face pressing operational and financial challenges. For these businesses, ESG considerations, despite being recognised as crucial, are often relegated. The General Provisions Applicable to Securities Issuers and other Participants of the Stock Market, while endorsing ESG, are optional, resulting in a spectrum of adoption rates and a piecemeal landscape.

One significant challenge ahead is the formulation of clear, unequivocal ESG standards. The shadow of 'greenwashing' looms large, with concerns over misrepresentations of eco-friendliness, particularly in the absence of rigorous certification benchmarks. While ESG reporting is on an upswing, there is a pressing need for greater precision, depth and authenticity. Instruments like the Mexican Sustainable Taxonomy, though laudable, must evolve further to truly align with the green and sustainable benchmarks.

Mexico is poised at a critical crossroads. With global ESG standards increasingly coming to the fore, there is a momentous opportunity to entrench these values deeply within national projects, policies and corporate blueprints. The shifting geopolitical scene, marked by changes in global supply chains and the rising potential of nearshoring, places Mexico in a unique vantage point. By carving a niche as not only economically viable but also ESG-compliant, Mexico stands to attract substantial investments, spurring both economic and sustainable progress.

Certain sectors, like real estate, are already reflecting this ESG-centric trend. However, the voyage is ongoing. Myths about the prohibitive costs of ESG integration, especially among SMEs, need dispelling. The 'greenwashing' peril, due to vague certification guidelines, requires swift redress.

Initiatives, including the Mexican Sustainable Taxonomy and the Sustainable Finance Mobilization Strategy, need constant re-evaluation and updating. The taxonomy should be revisited periodically to encompass novel technologies and methodologies bolstering sustainability. The Sustainable Finance Mobilization Strategy should synergise with private-sector endeavours, ensuring a marriage between policy directives and market innovations. This will be paramount to keep Mexico not just in tune with global shifts but also pioneering in some aspects of sustainable finance.

For a successful journey, a comprehensive, future-oriented strategy, punctuated by regular enhancements of tools such as the Mexican Sustainable Taxonomy and strategies such as the Sustainable Finance Mobilisation Strategy, is essential. Augmented by steadfast dedication from stakeholders across the spectrum, these efforts will shape Mexico's sustainable finance trajectory in the coming decades.

In its ambition to lead the way in sustainable progress, Mexico requires a unified, collaborative approach. This calls for the active involvement of the private sector, regulators, social influencers and the broader public. By emphasising transparent and mandatory ESG reporting, aligning with international best practices and cultivating sincere commitment, Mexico can truly tap into its potential in the sustainable finance domain.

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Introduction

From when Myanmar began her democratic transition in 2011 to today, financial sector reforms were prominent as they were viewed as ensuring the inclusiveness of different socioeconomic groups and classes. Even during the democratisation process, the public's trust in the formal financial system was low. Private banks were perceived to be only serving a small elite class.[2] The current banking and financing framework in Myanmar is vastly regulated by the following legislation:

1. the Microfinance Business Law 2011;
2. the Foreign Exchange Management Law 2012;
3. the Central Bank of Myanmar Law 2013;
4. the Securities Exchange Law 2013;
5. the Public Debt Management Law 2016; and
6. the Financial Institutions Law 2016.

With these regulatory frameworks, the regulators made efforts to encourage the public to utilise the banking system for financial transactions and lending. The financial inclusion was on the rise due to the introduction of microfinance institutions (MFIs) and digital payment service providers.

Although several financial sector reforms were prioritised within a decade, the environmental, social and governance (ESG) considerations in financing remain mostly untouched. The regulators recognised the need to set up a financial mechanism to mobilise and channel sustainable financing for climate-resilient and low-carbon development. The Ministry of Planning and Finance (MoPF) adopted the Myanmar Sustainable Development Plan 2018–2030 (MSDP) in August 2018, and the Myanmar Climate Change Strategy 2018–2030 (MCCS) was adopted in 2019 by the Ministry of Natural Resources and Environmental Conservation (MoNREC) with insights from all key ministries and departments, city development committees, the Union of Myanmar Federation of Chambers of Commerce and Industry, academic institutions and civil society organisations. The government then pledged to strike the right balance between economic and social development, and environmental protection and sustainability. The third MCCS action area is to build a conducive financial environment and mechanism that can mobilise and allocate resources, enabling sectors to access and channel climate finance opportunities for inclusive investment in climate-resilient and low-carbon development. Within this context, the MCCS addresses that Myanmar needs to introduce a range of financial instruments – such as grants, guarantees, climate-smart insurance, loans and equity and debt-based financial instruments. As at the date of publication, there are no mandatory requirements or enacted legislation for sustainable financing. However, the initiatives underlined in the MSDP and MCCS are building blocks for sustainable finance reform in Myanmar.

Year in review

With the severe covid-19 pandemic and changes in the political landscape in 2021, the years after 2020 were challenging for all sectors in Myanmar, and the banking sector was one of the most severely impacted. Financial sector reform is 'at severe risk of stagnation or reversal'.[3]

After the pandemic first hit Myanmar in March 2020, the Central Bank of Myanmar (CBM) reduced its policy reference rate from 10 per cent to 7 per cent, effective 1 May 2020, as a response to mitigate the pandemic impact on banking sector. Banks' deposit rates were lowered to 5 per cent, and interest rates were increased to 10 per cent.

Immediately after 1 February 2021, banks faced staff absences and internet interruptions making even basic banking functions unavailable. The public's distrust of the formal financial sector was reignited, evident by long queues at ATMs and bank branches to withdraw savings deposits. The CBM responded by limiting the amount of cash that can be withdrawn weekly and requiring any payment over 20 million kyat to be made through digital transfer.

The key measures taken by the CBM, the central regulatory body for Myanmar's financial sector, in order to control the drastic impact on the currency can be summarised in five broad categories:

1. it responded to the depreciation of the kyat by temporarily suspending the reference rate and by adopting several measures aimed at slowing down the kyat depreciation;
2. it suspended the free spread range and revisited the managed floating exchange rate;
3. it allowed the use of additional currencies as official settlement currencies, including the Chinese yuan, Thai baht and the Japanese yen;
4. it significantly controls the usage of US dollars in the market; and
5. it proactively used bilateral currency to support trade, reduce US dollar–kyat exchange rate volatility and promote local currency in line with ASEAN financial integration.[4]

It is highly unlikely that the legal regime established and developed during 2011–2020 will be dismantled any time soon; however, changes may be brought by the military administration. The autonomy of CBM is already in question after the coup. The progressive development of sustainable financing will have to wait owing to the current unstable political environment.

Regulation and policy

As at time of writing, there is no enacted legislation that prescribes the governance of sustainable financing. Similar to financial sector, Myanmar's environmental sector is being developed and regulated by different legislation, policies and strategies, among which are:

1. the Environmental Conservation Law 2012;
2. the Natural Disaster Management Law 2013;
3. the National Biodiversity Strategy and Action Plan 2011, revised in 2015;

4. the Myanmar Action Plan for Disaster Risk Reduction 2017;
5. the National Environmental Policy 2018 and its implementation framework (under elaboration);
6. the Myanmar Sustainable Development Plan 2018;
7. the Conservation of Biodiversity and Protected Areas Law 2018;
8. the Forestry Law 2018; and
9. the Myanmar Climate Change Policy, Strategy and Master Plan 2019.

In the concept note made by the World Wide Fund (WWF) in November 2017, 'Unveiling a Green Economy in Myanmar', it was stated that the government was developing a green economy policy framework.[5] It is also known that the government was preparing its National and City Waste Management Strategy.[6]

It is part of the government's vision to establish a financial mechanism to mobilise and allocate finance for inclusive investment in climate-resilient and low-carbon development. This is also mandated by the National Adaptation Programme of Action as well as the Nationally Determined Contribution (NDC).

The Myanmar government acknowledges that international financial support is a core element to meet its NDC commitments.[7] Currently, more than US$85 million in grants and co-financing are being invested in adaptation projects and programmes.[8]

Sustainable finance instruments

Myanmar is in the process of developing several trust funds to support climate change initiatives and its sustainable goals. Myanmar has registered an independent conservation trust fund, known as the Myanmar Biodiversity Fund (MBF).[9] Its objectives are to support conservation of Myanmar's biodiversity, the protection of critical terrestrial and marine ecosystems, habitats and species, within and outside of protected areas and community conservation areas, and to support local communities and indigenous people as stewards of biodiversity, critical ecosystems and species, through environmentally sound land and resource-use practices and the management of local community conservation areas. The MBF is mandated to use 'funds in support of these objectives from domestic and international sources and invest and manage these funds in order to directly support the biodiversity conservation objectives above'.[10]

Myanmar is also in the process of developing an environmental management fund (EMF) as required by the Environmental Conservation Law 2012[11] and its Rules 2014.[12] The EMF will operate under an international best practices framework and will provide financial resources for environmental management across the country and support project activities in nine areas. It will be primarily funded by domestic sources, such as Union Consolidated Funds, income earned by the MoNREC from fees and compensation paid by polluters and payments for environmental services. Myanmar also urges international donors to support the EMF.[13]

In order to support sustainable development in Myanmar, it is required to strongly support the projects and businesses that are encouraging in environmental protection such as reducing carbon emissions, energy efficiency, pollution prevention and recycling.

The CBM plays a key role to deliver financing that encourages sustainable businesses to invest in green industries. At the time of writing, the government still cannot reach out to support green financing for the purpose of sustainable business strategy. Implementation on green financing cannot get the government's attention these days as the CBM is challenged with currency fluctuation. It should be possible for the government to promote and support business with sustainable impacts through financial instruments such as green loans, green bonds and sustainability-linked loans and the modernisation of legal and regulatory frameworks. In addition, there are no formal regulations that prevent or restrict banks, both government and private, from providing financial aid or lending to businesses or projects that can cause environment and social impacts.

However, the first Myanmar Green Loan was issued by OCBC Bank to Shwe Taung Group in accordance with Green Loan Principles (2008) by the Loan Market Association and the Asia-Pacific Loan Market Association. This US$44 million green loan was for a mixed-use project by Shwe Taung Group's subsidiary City Square Commercial Company Limited for the financing of Junction City Shopping Centre, Junction City Office Tower and Pan Pacific Hotel in Yangon's downtown. Its green features include energy-efficient electricity and mechanical systems that lower energy consumption, utilising double-gazed glass windows and installing rooftop solar panels that reduce energy consumed from the power grid. In addition, the project has a self-sustaining waste treatment system, ensuring a clean environment for the community. This landmark transaction proved that there is not only increasing awareness about climate change, but also the willingness to take action against it.[14]

Due to urbanisation, the large gap between rich and poor and an increase of migration, a shortage of smallholders and agricultural labour force in rural areas has arisen. Moreover, it is not easy for the farmers and smallholders to access financing due to short repayment terms, higher interest rates and other factors. Agricultural markets seem more and more underdeveloped and break apart. In Myanmar, being an agricultural country, the agriculture sector could be a considerable drive for economic development. To improve the financial intermediation for farmers and agricultural businesses, and to increase productivity and investment of those farmers and agribusinesses, the government of Myanmar – financed by the Japanese International Cooperation Agency (JICA) – implemented the Agriculture and Rural Development Two-Step Loan Project, which smoothly disbursed funds and completed activities in 2018. Private banks started to introduce financial products such as agriculture loans, commercial vehicle financing, farm machinery financing and heavy machinery financing.

Another sector is small and medium-sized enterprises (SMEs), which play an important role in the socioeconomic development of Myanmar. We find few private banks are encouraging loans for SME businesses. However, due to requirement of collateral and interest rates not much different from normal loans and with shorter repayment schedules, still it is unfavourable for SMEs. On the other hand, support and intervention from government is still weak, and in practice SMEs are still struggling for financing.

Sustainable disclosure requirements and taxonomy

At the time of writing, there are no sustainable finance disclosure requirements mandated by law. For financing purposes, banks normally use traditional know-your-customer (KYC) standards. The CBM currently only requires KYC for anti-money laundering and combating the financing of terrorism.

The Environmental Conservation Department of the MoNREC will develop an internal registry to track all the international support and climate financing received to fund the different sectoral adaption and mitigation projects through both government and non-government agencies.[15]

Myanmar also has not adopted the Task Force on Climate-related Financial Disclosures (TCFD) framework.

The Association of Southeast Asian Nations (ASEAN) developed the ASEAN Taxonomy for Sustainable Finance to serve as a common building block that enables an orderly transition and fosters sustainable finance adoption by the ASEAN member states.[16] It will act as 'a map to help guide capital towards activities that can promote the transition of activities in the real economy onto a more sustainable footing'.[17] The environmental objectives of the ASEAN Taxonomy are universal and applicable to all ASEAN Member States in alignment with their national environmental laws. Although the ASEAN Taxonomy is yet to be enforced, Myanmar will eventually be bound by its rules.

Under the ASEAN Taxonomy, the classification of activities will take place through the Foundation Framework (i.e., the qualitative assessment of activities as well as the Plus Standard, which uses metrics and thresholds to further qualify and benchmark eligible green activities and investments). Accordingly, an activity may be classified in one of the following six ways:

1. Green FF: Green Foundation Framework – clearly contributes to or enables climate change mitigation;
2. Amber FF: Amber Foundation Framework – activities contributing to decarbonisation where mitigation of other harm to environmental objectives is necessary;
3. Red FF: Red Foundation Framework – does not contribute to or enable climate change mitigation or fails to meet other safeguards;
4. Green PS: Green Plus Standard;
5. Amber PS: Amber Standard; and
6. Red PS: Red Plus Standard.[18]

The Plus Standard complements the Foundation Framework by providing activity-level criteria and thresholds to determine if an activity is green PS, amber PS or red PS.

ESG data, ratings and reporting

Due to rapid growth and being unprepared for impacts, Myanmar is now facing environmental and social issues. There is no mandatory regulation to provide formal ESG reports to government. However, the government passed the Environmental Conservation

Law for environmental management and regulation in 2012. With an open to global markets and welcome to investments approach, the government aimed to develop responsible investments that do not cause harm to the natural environment and the social environment for the interests of Myanmar and its citizens. Thus, the Myanmar investment law regulates prohibited investment activities that cause an enormous harmful impact to the natural environment and ecosystem and require prior approval of government and assessment from the key department, namely the Environmental Conservative Department. Investors backing these harmful activities are required to provide, depending on the scale and significance of the impacts that are likely to be caused by the proposed project, an environmental impact assessment (EIA), and initial environment examination (IEE) under the Environmental Conservation Law and Rules. According to World Bank, a total of 2,783 reports were submitted as at February 2019. Of these, 89.6 per cent have been replied to, but only 6.9 per cent of reports had been approved.[19]

In 2018, the government issued the notification in which it instructed the existing companies from nine promoted sectors to draft an environmental management plan (EMP). The aim was to obtain approval from the Ministry of Natural Resources and Environmental Conservation and to apply and implement this EMP. Those promoted sectors include alcohol, wine and beer production factories, food and beverage processing facilities, pesticide manufacturing, formulation and packaging plants, cement and lime manufacturing, textile and dyeing facilities, the foundry industry, tanning and leather finishing, pulp and paper mills and sugar manufacturing plants.[20]

Another report is an environmental audit, which is also under the Environmental Conservation Law, which is not yet in force but will be in the future, is a periodic, systematically documented and objective evaluation to determine factors such as whether the project, business or activity corresponds with regulatory requirements on environment conservation and whether it is using environmental management systems.

In the private sector, only a few companies have presented the sustainability report due to their holding or group's commitment to their home country. Although ESG reporting is not mandatory, some local companies are increasingly applying it to provide consistent and decision-useful information for market participants for investors.

Sustainable finance incentives

Nowadays, companies and corporations are increasingly aware of the concept of sustainability practices and actively engaged in corporate social responsibility (CSR) and ESG policies. Still, this awareness is comparatively weak in Myanmar, even among larger corporations with established brand reputations.

Previously, the government had set policies and plans such as the Covid-19 Economic Recovery Plan (CERP), in which a concessional loan from Japan of ¥30 billion was provided to the government for the recovery of the private sector, sustaining macroeconomic stability and revitalising business activities through advance financial platforms.[21] Other incentives, such as agriculture loans, SME loans and two-step loans, were provided and encouraged by the Myanmar government.

Now, the government is drafting the Myanmar Economic Resilience and Recovery Plan (MERP) aligned with the Myanmar Sustainable Development Goal for the recovery of the country's economy in the long run. Due to the pandemic and political issues, Myanmar has faced an economic slowdown, financial instability, inflation and other downsides. Though the MERP has not been published yet, it is expected to focus more on financial stability, encourage macroeconomics and prioritise the sustainable and green economy. In the private sector, based on the conversation with an officer from one leading local bank, the banks are willing to encourage and support every business, especially agriculture and the SME sector, and in the past, they usually provided unique loan facilities and financial products to those who needed them.

Currently, both the government and banks are struggling with their own way during this survival period. Green financing is one of the incentives for the Myanmar government to consider, and this is expected to be included when the MERP published.

Carbon markets and carbon trading

Myanmar remains absent from any international carbon markets, and the concept of carbon pricing has yet to be entertained by the government. However, Myanmar has taken steps towards potential future participation in these markets, particularly in the context of the clean development mechanism (CDM) and gained some experiences with a number of CDM and joint crediting mechanism (JCM) projects under implementation.[22]

In 2013, Myanmar and China signed a memorandum of understanding (MoU) to foster the development of carbon-cutting projects under the CDM. The MoU aimed to promote the exchange of information and technology between the two countries and facilitate the development of CDM projects in Myanmar.[23] Building on its commitment to environmental sustainability, Myanmar took a more significant stride in 2016 by signing the Paris Agreement, an international treaty designed to combat climate change, through setting ambitious goals for reducing greenhouse gas emissions and mitigating the global warming.[24] Notably, the Paris Agreement incorporates provisions for establishing a global carbon market, presenting opportunities for Myanmar to participate in international emissions trading. As the international landscape continues to evolve, Myanmar's experiences with CDM and JCM projects may position it strategically for potential future engagement in emerging carbon markets.

Green technology

Significant economic development with no environmental safeguards has led to Myanmar facing many climate change and deterioration of ecosystem downsides. CO2 emissions in Myanmar increased to 36,720kt in 2019 from 32,940kt in 2018.[25] As Myanmar is a developing country and the awareness of environmental protection is weaker than in other ASEAN countries, every sector is starving for innovative technology. Though Myanmar has an abundance of natural resources, it cannot pursue the management of natural resources. But as a significant matter, waste management technology with help from Japan together with government are implemented in Yangon for all disposal of solid waste. The government is willing to support innovative technology for a green environment and expected to collaborate with other private bodies that can bring new technology. Though the government set up strategies and policies, due to the pandemic and government changes, the progress on environmental development has become slow. However, we expect more investment and projects that can encourage environmental development and hope the government will support and provide incentives such as green finance for private entities.

Climate change, nature and biodiversity impacts

With regard to environmental conservation, government departments normally take criminal actions against perpetrators. The most commonly violated environmental laws are the Forestry Law and the Natural Disaster Management Law 2013. Enforcement actions are comparatively weak and selective. The Disaster Management Law was widely used during the covid-19 pandemic to take action against those who broke covid-19 preventive restrictions.

The data for accurate numbers of lawsuits and cases is not publicly available. In 2017, around 2,400 cases were brought by the government across the country.[26]

Greenwashing and climate litigation risks

The Environmental Conservation Law (2012) and Environmental Conservation Rules (2014) lay out the regulatory framework governing the maintenance of natural and social environments for both domestic and foreign investments within Myanmar. While these legal instruments provide comprehensive provisions, there is an absence of explicit terms or prohibitions regarding greenwashing. The government, in 2016, established a set of environmental quality standards, along with environmental impact assessment and social impact assessment procedures that are designed to ensure that businesses and investors adhere to specified standards, preventing them from engaging in deceptive activities that could negatively impact the environment and the economy.[27] In addressing greenwashing, companies and financial institutions are mandated to disclose their environmental impacts and sustainability practices in a clear and transparent manner and raise awareness to consumers about greenwashing and how to identify misleading environmental claims.

The Environmental Conservation Law, Environmental Conservation Rules and EIA and SIA procedures also help increasing availability of legal resources for climate litigation. Despite the adoption of the MSDP (2018–2030), there has been limited evidence of a notable surge in climate litigation within the jurisdiction. The government, while not actively pursuing greenwashing, has yet to implement specific initiatives and regulations to address this issue. The current administration's stance on regulating greenwashing in Myanmar remains unclear, with no reported initiatives in place as at the time of writing. Nevertheless, several factors, such as the escalating frequency and severity of climate change impacts in Myanmar, including extreme weather events and rising sea levels, coupled with an increasing recognition of the role of corporations and governments in causing climate change, might lead to the emergence of climate litigation in the country in near future.

Outlook and conclusions

Considering the possibility of holding a general election and unstable political situation in Myanmar, very little progress should be expected for sustainable finance legislation. The suspension of operations in Myanmar by the World Bank Group and Asian Development Bank (ADB) since early 2021 left a void in essential technical assistance and financial support to implement its planned actions and strategies by the government. Despite those challenges, Myanmar owns a wide area of forestry and a long line of coastal areas, and banks may play a crucial role in financing to develop resorts and natural parks.

Endnotes

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Summary

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Introduction

In 2016, Portugal was a pioneer in taking the political commitment to achieve carbon neutrality by 2050, as a contribution to the Paris Agreement (2015) and in line with the more ambitious international efforts for deep decarbonisation.

Ever since, the state has been performing an active role in defining and adapting the national regulatory system to facilitate the transition to a new economic growth model characterised by investment in sustainable projects and activities.

One of the vectors underlying the Portuguese sustainability strategy is catering for adequate financing conditions and increasing investment levels. The Portuguese lead regulators in the financial sector are aligned with this strategy and goal.

In parallel, the main entities of the financial sector in Portugal (such as the government's ministries, the Portuguese lead regulators, financial industry associations and banks) have voluntarily subscribed to a Charter of Commitment for Sustainable Finance in Portugal, aiming to promote the incorporation of environmental and sustainability criteria into the financial sector's activity to achieve a carbon-neutral economy by 2050.

This joint traction force awakened other financial market participants to understand the importance of redirecting capitals towards sustainable finance to strengthen the economy.

This domestic panorama cannot be read in isolation, as it is closely related to the international, and particularly the European, tendencies and progress to limit global warming and procure the transition to a carbon-neutral economy.

Year in review

Recently, Portugal's public entities and private sector actors have been increasingly committed to promoting sustainable finance.

In this regard it is worth noting that most regulation impacting sustainable financing in Portugal stems from the European Union and is directly applicable in the country, notably the Sustainable Finance Disclosure Regulation (SFDR), the EU Taxonomy Regulation and the very recently approved EU Green Bonds Regulation.

Further, in the recent past, the lead regulators in these matters have not published any divergent approach from the European Union's requirements. Notably, the Portuguese Securities Market Commission (CMVM) favours an approach of supervisory convergence. In addition, the CMVM and the Supervisory Authority for Insurance and Pension Funds (ASF) have highlighted the importance of guidance published by the European Supervisory Authorities and encouraged in-scope firms to comply with the European implementation requirements, particularly from the SFDR.

The Framework Law on the Climate (2021), approving the grounds for the climate policy, represents a national milestone. This Law imposes a general duty of non-harm to climate and environmental balance and applies to any private company. It: (1) sets out the guiding principles applicable to financial policies, financial management and support to capitalisation and financing; (2) imposes the obligation of considering, in financing decisions, climate risk and impacts; and (3) imposes obligations on companies to consider climate change within their corporate governance and to incorporate the analysis of climate risk into their decision-making processes, as well as disclosure obligations. Additional regulatory implementation of the Framework Law on the Climate is expected in the upcoming years.

Further, other recently passed national laws, such as the Asset Management Regime (2023) and the Investment Firms Regime (2021) have also been designed to include certain duties regarding the integration of sustainability criteria and the consideration of sustainability risks.

In parallel, in the past year the Portuguese state has confirmed to be evaluating a potential issuance of green bonds.

Regulation and policy

i Governance regime

Portugal has been a part of the European and global efforts to promote environmental sustainability since the beginning of the millennium and joined the United Nations Framework Convention on Climate Change, the Kyoto Protocol and the Paris Agreement.

Additionally, and given that Portugal is a member of the European Union, its legislation is highly influenced and impacted by the European Union regulations,[2] which are applicable in this jurisdiction.

Furthermore, at a national level, there has also been an effort to pursue a sustainability agenda. To this end we highlight the following legislation and commitments, which have been recently adopted:

1. the Framework Law on the Climate (Law No. 98/2021, of 31 December 2021);
2. the Investment Firms Regime (Decree-Law No. 109-H/2021, of 10 December 2021);
3. the Asset Management Regime (Decree-Law No. 27/2023, of 28 April 2023);
4. the National Energy and Climate Plan (PNEC) approved by the Resolution of the Council of Ministers No. 53/2020, of 10 July 2020;
5. the Roadmap For Carbon Neutrality 2050 (RNC2050), approved by Resolution of the Council of Ministers No. 107/2019, of 1 July 2019;
6. the Letter of Commitment for Sustainable Financing in Portugal;
7. the Bank of Portugal's commitment to sustainability and sustainable financing, approved in 2020;
8. the Portuguese Securities Market Commission's (CMVM) notice on capital markets and sustainability, of December 2021; and
9. the Corporate Governance Code of the Portuguese Institute of Corporate Governance from 2018, as revised in 2023.[3]

All the above contain, to a greater or lesser degree, sustainability-related requirements, commitments or strategies. With reference thereto, we take this opportunity to highlight that the Framework Law on the Climate condenses the guidelines for Portuguese climate policy, with the aim of achieving carbon neutrality in the country. It focuses on various sectors, including the energy industry, construction, agriculture, fisheries and financial assets and green taxation. In addition to what has been referred to in the previous Section, specifically in the context of sustainable financing, the Framework Law on the Climate sets forth:

1. a set of sustainable financing principles to guide the activity of financial management, capitalisation support and loan contracting;
2. that any lack of transparency or failure to share information regarding the consideration of climate risk and climate impact in financing decisions is considered an inadequate sale, under the terms of the regulation on markets in financial instruments;[4] and
3. that the analysis of risk in financial intermediation should consider the climate risk and climate impact of the activities that seek financing.

ii Regulators

In Portugal, the main public bodies in charge of regulating, enforcing and promoting financial sustainability are the Ministry of Internal Administration, the Ministry of the Environment and Climate Action and the Ministry of the Economy and the Sea, and the regulatory triad composed of the Bank of Portugal, the Portuguese Securities Market Commission (CMVM) and the Insurance and Pension Funds Supervisory Authority (ASF).

Additionally, as Portugal is a member of various international treaties and a Member State of the European Union, it is also subject to further supervision, notably by the following European Supervisory Authorities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

Sustainable finance instruments

Sustainable financing is one of the key pillars of the European Union's action plan for sustainable growth, which will create the conditions to support companies and the economy in their efforts to converge towards sustainability. As a Member State of the European Union, Portugal follows its ideologies and promotes the development of sustainable financing in its territory.

The issuance of green bonds has become one of the most popular and important financing instruments for sustainable projects in Portugal. In the past two years, several relevant Portuguese companies and banks have issued this type of instrument, such as EDP - Energias de Portugal, REN – Redes Energéticas Nacionais, Sonae Capital, Greenvolt, Caixa Geral de Depósitos, Millennium BCP and Secil.

In the medium term, the green bond market in Portugal is expected to start adjusting to the standards and requirements of the recently approved European Green Bonds Regulation (2023) – still to enter into force, which outlines voluntary guidelines for issuing environmentally sustainable bonds bearing the 'European green bond' (EuGB) label. The primary objective of this Regulation is to enhance investor protection through the EuGB label and mitigate the risks associated with greenwashing, by setting a high standard for green bonds, often referred to as the 'gold standard'.

A key aspect of this Regulation is the requirement for the use of proceeds from the bonds to be in line with the EU Taxonomy, to ensure that the funds raised through EuGBs contribute to the EU's broader goals of environmental sustainability and climate neutrality.

Furthermore, the European Green Bonds Regulation mandates that EuGBs are to be supervised by competent authorities as per the EU Prospectus Regulation. In Portugal, this supervision is the responsibility of the CMVM. This regulatory oversight is critical for maintaining the integrity of the EuGB label and ensuring compliance with the outlined criteria. It further underscores the accountability and transparency that is expected in the issuance and management of EuGBs.

In this respect, it is also worth mentioning some more recent trends in Portugal in the issuing of sustainability-linked bonds and sustainability-linked loans, both having their interest rate payments indexed to the fulfilment of certain sustainability targets (mainly concerning climate or gender equality).

Lastly, we should mention the importance of green loans in the Portuguese financial market, as there has been a proliferation of this type of financing in the past two years.

To date, it is common for these sustainable finance instruments to be aligned with the Green Bond Principles, Social Bond Principles, Sustainability Bond Guidelines and Sustainability-Linked Bond Principles of the International Capital Market Association (ICMA) and the Green Loan Principles, Social Loan Principles and Sustainability-Linked Loan Principles of the Loan Market Association.

Sustainable disclosure requirements and taxonomy

Portugal, being a Member State of the European Union, takes into account the criteria set out in the European legislation.

In terms of sustainable disclosure requirements, SFDR on sustainability related disclosures in the financial services sector, and the respective delegated regulations,[5] are directly applicable in Portugal. These regulations aim to achieve transparency in the way financial market players take sustainability risks into account in their investment decisions or investment advisory activities, promoting transparency towards end investors for companies in the financial services sector.

The EU Taxonomy Regulation[6] is also applicable to Portugal, establishing measures that impose requirements on financial market players or issuers with regard to financial products that are made available as being environmentally sustainable.

The EU Taxonomy Regulation aims to provide companies and investors with a common language (taxonomy) to identify economic activities that can be considered sustainable through the implementation of environmental goals. The establishment of this single classification system for environmentally sustainable activities aims to allow investors to redirect their investments towards more sustainable technologies and companies.

ESG data, ratings and reporting

Portugal's landscape of reporting requirements concerning sustainable investments and greenhouse gas emissions is nuanced by a confluence of national regulations and overarching European Union directives. At the national forefront, Portugal has instituted regulations and guidelines directing companies to disclose their sustainability practices, encompassing environmental, social and governance (ESG) practices, inclusive of greenhouse gas emissions reporting, such as the Framework Law on the Climate or the (soft law) Corporate Governance Code. These national frameworks align with the European Union guidelines, interspersed with specific national provisions, epitomising a concerted effort to engender a culture of transparency, accountability and sustainability within the corporate and financial sectors.

The narrative of sustainable reporting in Portugal is further enriched by the European Union's Corporate Sustainability Reporting Directive (CSRD)[7] and the SFDR.

Prior to the CSRD, European Union Law already mandated certain large companies (i.e., with over 500 employees) and certain listed companies to submit an annual non-financial statement encompassing information on environmental, social and other related issues, trough the NFRD.[8] In a bid to standardise non-financial information reporting, the CMVM issued a non-binding template in February 2021. This initiative aimed to harmonise the non-financial information reported by companies required to disclose this information, providing a semblance of uniformity in reporting practices.

The CSRD entered into force on 5 January 2023, to strengthen the rules on the social and environmental information that companies must report. It has a broader scope of application, covering more large companies (i.e., companies meeting two of the following criteria: (1) balance sheet total over €20 million; (2) net turnover over €40 million; and (3) an average of over 250 employees during the financial year), as well as listed SMEs, which will now be required to report on sustainability (i.e., companies meeting two of the following criteria: (1) balance sheet total over €4 million; (2) net turnover over €8 million; and (3) an average of over 50 employees during the financial year[9]). The first group of companies subject to the CSRD's requirements in 2024 will have to publish their reports in 2025, in accordance with the European Sustainability Reporting Standards (ESRS).

Conversely, the SFDR obliges financial market participants and advisers within the European Union's ambit to disclose how they integrate ESG risks into their investment decisions and advisory processes.

Under the National Energy and Climate Plan (PNEC), approved in May 2020, Portugal set targets for reducing greenhouse gas emissions, incorporating renewable energy and improving energy efficiency, with a commitment to communicate information on greenhouse gas emissions as per European Union Directive 2003/87/EC, establishing a scheme for greenhouse gas emission allowance trading.

The private sector in Portugal is progressively aligning with ESG principles, underpinned by several national associations committed to promoting sustainability within business echelons. The Business Council for Sustainable Development in Portugal (BCSD Portugal) is notably at the forefront of this drive.

Voluntary ESG disclosure frameworks such as the Global Reporting Initiative (GRI) Standards, integrated reporting guidelines by the International Integrated Reporting Council (IIRC), and adherence to the Sustainable Development Goals set forth by the United Nations have gained traction.

A significant stride in Portugal's ESG reporting landscape is the enactment of the Framework Law on the Climate (FLC) on 31 December 2021, mandating companies to embed climate change considerations in their corporate governance and integrate climate risk analysis into their decision-making processes. It also requires an annual assessment of the economic, environmental and social dimensions of their activities and operations concerning climate change, which should be integrated into their management reports. The law hints at future amendments to existing legislation to encapsulate the duties outlined in the FLC.

Further influencing the regulatory landscape are Decree Law 27/2023 and Decree-Law 109-H/2021. The former contains the national Asset Management Regime, under which asset managers shall take into account sustainability risks and sustainability factors. The latter approves the regime for investment firms, mandating the integration and weighting of risk and sustainability factors in the governance and distribution of financial instruments.

The realm of ESG data reporting in Portugal is underlined by an increasing awareness of sustainability factors among investors, asset managers and other stakeholders, driven by ethical imperatives and a desire for sustainable long-term returns. However, the emergent character of ESG reporting in Portugal poses challenges that require attention to ensure the genuineness of sustainability efforts and to prevent the peril of greenwashing.

Portugal, under the aegis of European Union regulations, has embraced the paradigm of sustainable or green benchmarks, including European Union Paris-aligned Benchmarks and Climate Transition Benchmarks and sustainability-related disclosures for benchmarks (Regulation (EU) 2019/2089), reflecting Portugal's commitment to the broader sustainable finance agenda promulgated by the European Union.

The SFDR Level 2 regulations,[10] supported by the Regulatory Technical Standards (RTS) adopted by the European Supervisory Authorities (ESAs), strive to enhance both qualitative and quantitative assessments alongside mandating the disclosure of adverse sustainability impacts under the SFDR.

In Portugal, the emphasis on sustainable finance is evidenced by the proactive stance of the Bank of Portugal in integrating sustainability within its strategic objectives and operational activities, including the consideration of ESG factors in its investment decisions. The Bank of Portugal also engages in international initiatives pertinent to sustainable finance, such as the Network for Greening the Financial System (NGFS) and the Sustainable Insurance Forum (SIF), demonstrating a broader commitment to global sustainability objectives. Furthermore, analysis on climate change implications for the financial system also forms part of the Bank of Portugal's initiatives, aiding in comprehending the risks and opportunities associated with sustainability.

Sustainable finance incentives

Following the creation of Next Generation EU,[11] Portugal's Recovery and Resilience Plan (PRR) was introduced. The Portuguese PRR is a nationwide programme, to be implemented until 2026, which will introduce a series of reforms and investments designed to guide the country towards sustained economic growth and convergence with the rest of Europe during the next decade, guided by a concept of sustainability inspired by the United Nations' Sustainable Development Goals.

The PRR materialises as a fundamental instrument for promoting environmental sustainability in Portugal and also for financing green projects capable of stimulating sustainable growth in the Portuguese economy.

Carbon markets and carbon trading

Mandatory participation in carbon trading schemes within Portugal is largely driven by its membership of the European Union, which has pioneered the European Union Emissions Trading System (EU ETS). The EU ETS emerges as a quintessential archetype of a cap-and-trade system, where a cap is instituted on the total emissions permissible from a spectrum of industrial installations.

National allocation plans (NAPs) were instrumental during the nascent phases of the EU ETS, specifically during the first and second trading periods spanning 2005 to 2012. Portugal, akin to other European Union Member States, was mandated to articulate a NAP, delineating the total quantum of allowances to be distributed among the installations within its jurisdiction. This was an exercise in aligning national circumstances with the overarching European Union objective of emission reduction.

Decree-Law No. 12/2020, of 6 April 2020, delineated the legal framework pertinent to the trading of greenhouse gas emission permits for the fourth trading period (2021 to 2030). This legal framework is emblematic of Portugal's commitment to adhere to evolving European Union regulations and ensure a seamless transition into new trading periods with refined regulatory stipulations. The EU ETS, known in Portugal as 'O Comércio Europeu de Licença de Emissão' (CELE) was amended by Directive (EU) 2018/410 to enhance cost-effective emission reductions and low-carbon investments across the European Union. This Directive was transposed into Portuguese law through Decree-Law No. 233/2004, aligning the national regulatory framework with the broader European Union climate objectives and ensuring the systematic implementation of the cap-and-trade mechanism within Portugal.

Beyond the mandated realms of the EU ETS, Portugal has exhibited a proactive stance towards fostering a conducive environment for voluntary carbon trading. This is notably embodied in the initiation of a voluntary carbon market (VCM) at the terminus of 2020. The VCM is envisioned as a regulated marketplace for voluntary carbon credits, with a draft decree-law propounded to delineate the regulatory framework, thereby mitigating risks associated with greenwashing and enhancing the confidence of investors and purchasers in carbon credit products. Furthermore, the establishment of the Portuguese Carbon Fund illustrates a financial mechanism aimed at facilitating Portugal's navigation through the carbon market, ensuring compliance with national climate targets.

Green technology

Portugal's exploration of emerging technologies, including hydrogen and battery storage solutions, paints a vivid picture of innovative initiatives aimed at accelerating the transition to clean energy and bolstering climate resilience. The European Investment Fund plays a crucial role in facilitating this journey by directing investments toward Portuguese companies involved in this transformative process. This aligns with the broader European goal of promoting a sustainable marine environment and a circular economy. The connection between these emerging technologies and sustainable finance is underscored by the proactive approach of Bank of Portugal, which actively supports sustainable finance by identifying, assessing and managing financial risks stemming from climate change.

Within the hydrogen sphere, Portugal has conspicuously etched its ambition, actively probing the potential of hydrogen as a harbinger of clean energy. The country's targets for both the production and consumption of green hydrogen are emblematic of its broader energy transition agenda. In parallel, the narrative on battery storage solutions unveils another facet of Portugal's sustainable finance landscape. Driven by the push towards harnessing renewable energy sources such as solar and wind, the integration of battery storage stands as a pragmatic approach to grid balance and ensuring a steady power supply. This pragmatic orientation has morphed the sector into an attractive conduit for sustainable finance investments.

Climate change, nature and biodiversity impacts

The European Parliament's evaluation of Portugal's National Energy and Climate Plan (NECP) for 2021–2030 praises the nation's dedication to increasing the share of renewable energy, improving energy efficiency and curbing greenhouse gas emissions. This recognition extends to the 'just transition mechanism', representing a holistic approach to ensure no communities are marginalised in the transition towards a green economy. However, there is an indication of the need for enhanced efforts, particularly within the transport sector.

Various frameworks and projects signify Portugal's strategic movement towards its climate and nature-oriented objectives. The National Roadmap for Adaptation 2100 project, coupled with the National Climate Change Adaptation Strategy, highlight a unified effort to analyse and tackle the impacts of global warming, with a focus on key vulnerabilities such as coastal erosion, forest fires and storm surges. This strategic framework, supported by numerous action programmes and municipal plans, articulates a comprehensive approach to climate resilience, with a particular emphasis on the energy sector. The nation's achievements in renewable energy and biodiversity conservation are acknowledged, yet challenges lie ahead requiring strong governance, strategic investments and a harmonised global legal framework.

The extension of Portugal's National Climate Change Adaptation Strategy to 2025 lays a strong emphasis on bolstering the energy sector against climate adversities, understanding that vulnerabilities in this sector could amplify challenges in others. It advocates for integrated contingency plans to counter the ripple effects of cascading failures, with a multi-dimensional approach to climate resilience encompassing land use, water resource management and transport.

The legal mandate under the Climate Framework Law is mirrored in the Bank of Portugal's Annual Report on the Banking Sector's Exposure to Climate Risk. This report dissects the potential repercussions of climate risks on the banking system, unveiling a significant exposure to water stress, heat stress and wildfires, while showcasing a reduced exposure to transition risks as gauged by greenhouse gas emissions from various sectors. Additionally, the Bank of Portugal's involvement in the European Single Supervisory Mechanism (SSM) highlights a broader commitment towards enhancing the prudential supervisory framework for 2023–2025, with climate-related and environmental risks earmarked as supervisory priorities.

The launch of the National Roadmap for Adaptation 2100 (RNA 2100) by the Portuguese Environment Agency in September 2020, alongside the Action Programme for Adaptation to Climate Change (2019), outlines nine action lines focused on critical climate impacts, emphasising wildfires, floods and energy sector resilience. By 2030, it envisages all energy companies to have climate adaptation and contingency plans in place, embodying a proactive industry-wide approach to climate resilience.

Furthermore, the elucidation of physical and transition climate risks continues through the RNA 2100 project, which examines the impacts of global warming on hydrological balance, forest fires, agroforestry, sea level rise, coastal erosion and storm surges. The transition to a low-carbon economy is spotlighted by Wellington Portugal Institutional's report on climate change physical and transition risks, emphasising the importance of understanding the risks and opportunities inherent in this transition.

Moreover, the Climate-ADAPT platform and the National Adaptation Strategy (NAS)'s monitoring and reporting system represent a robust information and assessment framework, facilitating a nuanced understanding of climate change projections, vulnerabilities, and sector-specific indicators. This mechanism assures a continuous evaluation and recalibration of adaptation actions across various sectors, fostering a dynamic approach to climate risk management.

In summary, Portugal's multifaceted approach towards identifying and managing physical and transition climate risks embodies a proactive and holistic methodology, especially in the energy and banking sectors. However, as highlighted in the nation's strategies, continuous monitoring, assessment and adaptation are essential to effectively navigate the changing climate conditions, thereby ensuring a sustainable and resilient future.

Greenwashing and climate litigation risks

Portugal, conforming to the European Union's directives and regulations, is taking steps in confronting 'greenwashing' and other ESG-related challenges. The two primary forms of greenwashing in Portugal are:

1. misleading product information: Companies may exaggerate or provide false information regarding the eco-friendliness of their products or services. They may use deceptive labels or ambiguous terms that mislead consumers into thinking they are making environmentally responsible choices; and
2. misleading annual reporting of non-financial information: Companies might manipulate or misrepresent data in their annual reports to give a façade of environmental responsibility. This misrepresentation can mislead stakeholders about the company's actual environmental and sustainability practices. The Corporate Sustainability Reporting Directive (CSRD) aims to address this by

promoting transparency and standardisation in sustainability reporting within the European Union, ensuring accurate and comparable sustainability information is provided. A blend of mandatory regulations, voluntary initiatives and active private sector engagement underscores a holistic approach towards fostering transparency, accountability, and a genuine commitment to sustainability goals.

Portugal is actively addressing greenwashing challenges to promote transparency, accountability and a genuine commitment to sustainability. A significant part of these efforts is the active role played by the CMVM, which has initiated targeted supervisions to mitigate the risks associated with greenwashing, specifically focusing on the quality of information provided in green bond prospectuses and in annual non-financial information reports disclosed by issuers. Through these supervisions, the CMVM aims to ensure that the information presented to investors and the public is accurate and transparent, thereby contributing to the broader national effort to combat deceptive sustainability claims and promote genuine sustainable practices within the private sector.

Portugal is aligned in following the ESMA's guidelines for the use of ESG or sustainability-related terms in fund names. In order not to mislead investors, the ESMA believes that ESG- and sustainability-related terms in fund names should be supported in a material way by evidence of sustainability characteristics or objectives that are reflected fairly and consistently in the fund's investment objectives and policy.

At the regulatory forefront, the Portuguese Consumer Authority (DGC), mandated with overseeing consumer protection and advertising activities, has emerged as a vanguard against misleading advertising and greenwashing. In a collaborative endeavour with the national Self-Regulatory Entity for Advertisement, the DGC unveiled a seminal report in August 2021 delineating the contours of greenwashing practices. This document serves as a guiding light for economic operators, enshrining the imperative of ensuring that environmental claims are rooted in verifiable scientific facts and articulated in a truthful, clear and precise manner. The report also furnishes a practical checklist to gauge the alignment of environmental claims with international standards of fair advertising practices.

The quest for conceptual uniformity has culminated in the promulgation of Decree-Law No. 78/2021, especially to clarify ambiguous terms like 'biodegradable plastic', which could otherwise mislead consumers. This legislative intervention underscores the nation's resolve to bridge the informational asymmetry between consumers and organisations, a critical step towards fostering an informed consumer base capable of making discerning choices in the green financial market. Furthermore, the Bank of Portugal is adopting a green mantle by advocating for environmental sustainability in financial management and resource allocation, reflecting a broader institutional acknowledgement of sustainability imperatives. In this way, Portugal is promoting an environment of transparency, consumer protection and environmental sustainability to combat greenwashing and promote a credible green financial market.

Climate litigation in Portugal is taking its first steps since Portuguese jurisprudence has not yet recorded relevant cases of litigation (including class actions) used to guarantee adherence to climate objectives. However, it is important to note the alignment with the European Union's proposed Directive on Green Claims.

Outlook and conclusions

Businesses and financial entities in Portugal have been registering an increasing interest in sustainable finance. The number of entities in the financial sector promoting green, blue, social and impact financing and the number of transactions registered within this scope has been consistently increasing in recent years.

Although the sustainable finance requirements in Portugal arise mostly from the European Union's laws and regulations, such as the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation, specific national laws have also been enacted catering for the integration of sustainability principles and risks, and disclosure requirements (i.e., the Framework Law on the Climate, the Structured Deposits Law, the Asset Management Regime and the Investment Firms Regulation). Regulation in the financial sector is key, and the three lead Portuguese regulators (the CMVM, Bank of Portugal and ASF) have drawn up EU-aligned sustainability strategies and are committed to ensure that in-scope regulated companies maintain transparency in financial and sustainability practices.

Endnotes

1 Bruno Ferreira is managing partner, Rita Sacadura Orvalho is a senior counsel, Carolina Antunes is an associate and Raquel Burgoa Dias is a trainee in the banking and finance and capital markets practices at PLMJ Advogados. ^ Back to section

2 In this regard, we highlight: (1) Regulation (EU) No. 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability related disclosures in the financial services sector; (2) Regulation (EU) No. 2019/2089 of the European Parliament and of the Council of 27 November 2019 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks; and (3) Regulation (EU) No. 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment (also known as the EU Taxonomy Regulation). ^ Back to section

3 Note that this is not an exhaustive list. ^ Back to section

4 Regulation (EU) No. 600/2014 on markets in financial instruments. ^ Back to section

5 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019, Delegated Regulation (EU) 2022/1288 of the Commission of 6 April 2022 and Delegated Regulation (EU) 2023/363 of the Commission of 31 October 2022. ^ Back to section

6 Regulation (EU) No. 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment. ^ Back to section

7 Directive 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No. 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting. ^ Back to section

8 Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups. Portugal enacted the NFDR through Legislative Decree No. 89/2017. ^ Back to section

9 Starting in financial year 2026, reporting in 2027. ^ Back to section

10 Delegated Regulation (EU) 2022/1288 of the Commission of 6 April 2022, and Delegated Regulation (EU) 2023/363 of the Commission of 31 October 2022. ^ Back to section

11 An instrument of the European Union to invest in clean, healthy and digital technologies and build a greener, more digital and healthier Europe: NextGenerationEU (www.europa.eu). ^ Back to section

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Introduction

Singapore is establishing itself as a global hub for sustainable finance, leading the way in Asia through a blend of public and private sector initiatives. The Monetary Authority of Singapore (MAS) has been instrumental in this transformation, launching various funding schemes and guidelines for market participants to support green financing. With a strong focus on regulation, education, research, and transparent reporting, the Singapore government continues to foster a robust and sustainable financial ecosystem.

Year in review

In 2023, the Singapore government intensified its efforts to establish a reliable sustainable finance market, following its updated 2022 commitment to net zero emissions by 2050. To support this updated commitment, the government and other stakeholders have fostered a growing emphasis on transition finance, acknowledging the need for diverse strategies to achieve net zero. Improving the credibility of carbon credits and carbon markets is another significant trend. As a result of these efforts, Singapore has become a hub for green finance and sustainable investment in Asia.

Key regulatory, market and policy developments include:

1. Net Zero by 2050: This is Singapore's new national climate target. Singapore's Nationally Determined Contribution was also revised to pledge to lower emissions to approximately 60 MtCO2e in 2030 from 65 MtCO2e, and after peaking emissions earlier;
2. the Finance for Net Zero (FiNZ) Action Plan: This was launched by the MAS at the opening of the Sustainable and Green Finance Institute of the National University of Singapore. The FiNZ Action Plan sets out the MAS' strategies to mobilise financing to catalyse Asia's net zero transition and decarbonisation activities in Singapore and the region, including transition finance;
3. the Financial Services Industry Transformation Map 2025: This was announced by the MAS, laying out growth strategies to further develop Singapore as a leading Asian international financial centre that will connect global markets, support Asia's development and serve Singapore's economy;
4. climate-related reporting: This became mandatory in 2023 for Singapore public issuers in the financial, agriculture, food and forest products, and energy industries;
5. retail ESG funds disclosure and reporting obligations: These commenced on 1 January 2023; and
6. eligibility criteria under the International Carbon Credit (ICC) Framework: The Ministry of Sustainability and the Environment (MSE) and the National Environment Agency (NEA) established the eligibility criteria under the ICC Framework. The Singapore government introduced the ICC Framework in November 2022, alongside the progressive increase in carbon tax rate under the Carbon Pricing (Amendment) Act from the current S$5 per tonne of emissions to S$25 per tonne in 2024 and 2025, and S$45 per tonne in 2026 and beyond (see Section III). From 2024, the Economic Development Board will introduce a transition framework giving

existing emissions-intensive trade-exposed (EITE) companies more time to adjust to a low-carbon economy and to mitigate carbon leakage.

Regulation and policy

i Governance regime

Singapore is an early and committed contributor to global climate action, having ratified the United Nations Framework Convention on Climate Change (UNFCCC) in 1997, acceded to the Kyoto Protocol in 2006 and, more recently, ratified the Paris Agreement in September 2016. In alignment with the Glasgow Climate Pact signed at COP26, the Singapore government announced that it will raise its climate ambition to achieve net zero emissions by or around the middle of the century.[2]

ii Regulators

Singapore's central financial and securities regulators, the MAS and SGX, enforce sustainable finance policies to bolster the country's aim of becoming a global green finance leader.

The MAS launched the Finance for Net Zero (FinZ) Action Plan in 2023, which expands the scope of its 2019 Green Finance Action Plan to include transition finance. The FinZ Action Plan sets out the MAS' sustainable finance strategies to mobilise financing to catalyse Asia's net zero transition and decarbonisation, through four strategic outcomes:

1. promoting consistent, comparable and reliable climate data and disclosures;
2. fostering sound environmental risk management practices and deepening climate scenario analysis and stress testing;
3. supporting the development of credible regional sectoral decarbonisation pathways; and
4. promoting innovative and credible green and transition financing solutions and markets.

The MAS has also established the Green Finance Industry Taskforce (GFIT) to accelerate sustainable finance development. The GFIT has, to date, issued publications on taxonomy, climate-related disclosures, green finance solutions and environmental risk management, which guide the industry, inform policy-making and facilitate international engagements.

To promote the growth of sustainable finance solutions in Singapore, the MAS has introduced a number of sustainable finance instruments and incentives including the Green and Sustainability-Linked Loan Grant Scheme (GSLS) and Sustainable Bond Grant Scheme (SBGS) (see Section VII), Project Greenprint (see Section VI) and voluntary carbon markets (see Section IX).[3] The MAS' commitment to this goal is further demonstrated by its extension of the GSLS and SBGS for a further five years until 2028 with respect to transition bonds and loans.

Risk management frameworks

The MAS has systematically incorporated environmental risk into its supervisory framework for banks, asset managers, and insurers. It categorises environmental risk into financial and reputational risks. Financial risk includes the negative financial impact from environmental changes and regulations aimed at a low-carbon economy. Key financial risks for banks and insurers are market, liquidity and operational risks. Market risk arises from shifts in investor preferences affecting the valuation of carbon-intensive investments. Liquidity risk is heightened by natural disasters leading to higher property and casualty claims, fund redemption requests and demand for emergency loans. Finally, operational risk is posed by extreme weather events that can disrupt business continuity. The MAS also identifies credit risk as a concern for banks and, based on the MAS' guidelines, the threat of extreme weather events that reduce the value of assets that are held by banks poses significant credit risk. Furthermore, the transition to a low-carbon economy can impact the profitability and operation rights of carbon-intensive sectors, thus impacting borrowers' ability to pay back their debts. For insurers, risks include increased claims and underwriting losses due to frequent natural disasters.

MAS guidelines advocate a top-down risk management approach, where a company's board and senior management are responsible for creating an environmental risk management framework, integrating environmental considerations into business strategies, and supervising environmental risk management policies. The MAS suggests a 'three lines of defence' model for financial institutions: first, the business line adheres to the environmental risk management framework; second, the risk management function oversees these actions and third, the internal audit function independently assesses the robustness of the risk management framework.[4] The guidelines also encourage such institutions to oversee the environmental risks in their own portfolios as well as their clients' engagements, and to encourage clients to pursue greener practices.[5] Finally, the guidelines encourage institutions to develop tools and metrics to assess environmental risk exposures, engage in regular scenario analysis and stress testing and employ capacity building measures to enhance their risk management frameworks. Further, in October 2023 the MAS issued several consultation papers proposing guidelines on transition planning by banks, insurers and asset managers to enable a global transition to a net zero economy.

Regulations 13(B) and 54A of the Securities and Futures (Licensing and Conduct of Business) Regulations require all funds and mandates to establish a risk management framework, including environmental risk considerations. The MAS has detailed risk management strategies for different asset classes, including equity, fixed income and real estate. It has also provided guidelines for insurance underwriters to evaluate environmental risk. Like asset managers, insurers are legally required to implement risk management frameworks that include environmental risk management.

Disclosures

The MAS seeks to align Singapore's sustainability-related disclosure requirements with international standards set by the Task Force on Climate-related Financial Disclosures (TCFD) and the International Sustainability Standards Board (ISSB). Since 1 January 2023, listed SGX entities in the financial, agriculture, food and forestry products and energy industries, are subject to mandatory climate reporting, and all other issuers are subject to climate reporting on a 'comply or explain' basis. In addition, the MAS introduced disclosure and reporting guidelines for retail ESG funds to mitigate greenwashing risks.[6] Since 1 January 2023, retail ESG funds have been required to provide clear disclosures on their ESG investment objectives and approach, relevant ESG criteria and metrics and regular updates on how their ESG objectives have been met, or not met.

By the end of 2023, the GFIT plans to implement a Singapore–Asia taxonomy for green and transition activities (see Section V). This taxonomy will require Singapore-based financial institutions to use a 'traffic light' system, classifying activities as green or transitioning based on scientific criteria. Central to this is the 'Do No Significant Harm' assessment, ensuring activities contributing significantly to climate change mitigation do not harm other environmental objectives like climate adaptation, ecosystem and biodiversity protection, resource resilience and circular economy promotion and pollution prevention and control.

Code of Conduct

The MAS is contemplating a code of conduct for ESG rating and data product providers, setting baseline industry standards on governance, conflict of interest management and transparency in line with the International Organization of Securities Commissions (IOSCO) recommendations. The goal is to enhance market confidence in ESG ratings and data products, beginning with a voluntary industry code of conduct that could eventually become a formal regulatory framework.

International Carbon Credit (ICC) framework

The establishment of the ICC Framework and the International Advisory Panel for Carbon Credits supports Singapore's position as a carbon services and trading hub. The ICC Framework will allow carbon tax-liable companies to use eligible ICCs to offset up to 5 per cent of their taxable emissions from 1 January 2024. Eligible ICCs must fulfil all principles under Singapore's eligibility criteria, which include additionality, verification and no-double counting. A key criterion is also that there must be no 'leakage', meaning that the relevant project generating ICCs must not result in emissions elsewhere, as can occur by way of example when deforestation is simply relocated to another unmonitored area. The eligibility criteria will be reviewed periodically to align with developments in Article 6 of the Paris Agreement.

Other notable initiatives include:

1. fostering international partnerships in the global carbon market to open new sources of ICCs that meet Singapore's Eligibility Criteria. Singapore has substantively concluded negotiations with Ghana and Vietnam on implementation agreements setting out the requirements and processes for Article 6-compliant carbon credit cooperation. Carbon tax-liable companies can source ICCs generated under these implementation agreements to offset their taxable emissions;
2. the NEA developing a national registry to account for and track the ICCs surrendered by taxable facilities in compliance with Article 6 rules; and
3.

the International Emissions Trading Association (IETA) – a global non-profit – and Climate Action Data Trust (a global partnership between IETA, the World Bank and the government of Singapore) partnering to develop a data dashboard to provide an open-source, decentralised blockchain infrastructure that allows the public to access information about carbon credits issued across different registries globally, enhancing transparency and minimising double counting risk.[7]

Sustainable finance instruments

The demand for sustainable finance instruments is fuelled by factors such as increased retail demand, regulations promoting sustainable finance and the green economy, portfolio decarbonisation commitments and heightened awareness of climate risk exposure. Despite a contraction in the number of issuances in 2022 following a strong 2021, the ASEAN sustainable finance market remained robust with total issuances worth US$36 billion. Green bonds and loans fell by 26 per cent in 2022, while sustainability-linked bonds dropped by 90 per cent. Singapore led the region, accounting for 60 per cent of sustainable debt issuances in 2022.[8]

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i Green bonds

Green bonds are debt securities whose proceeds are exclusively used for projects with climate and environmental benefits, as per specific issuance principles or guidelines. Issuers can adopt frameworks like the International Capital Market Association (ICMA) Green Bond Principles 2021 or the Climate Bonds Standard to qualify their issuance as a green bond. Notable Singapore issuers include major banks such as DBS Group and OCBC Bank, which have developed their own frameworks – the DBS Green Bond Framework and OCBC Sustainability Bond Framework, respectively.

The Ministry of Finance has a national Green Bond Framework, setting the groundwork for the government's green bond issuance under the Significant Infrastructure Government Loan Act 2021. The Framework aligns with international principles and practices, including the ICMA Green Bond Principles 2021 and the ASEAN Capital Markets Forum ASEAN Green Bond Standards 2018. It outlines eight categories of green projects eligible for financing by Singapore sovereign green bonds. The issuer must use the green bond proceeds for eligible green expenditures that contribute to the environmental objectives outlined in the ICMA and ASEAN standards. In 2022, the government issued its S$2.4 billion inaugural sovereign green bond, which was priced at a 3.04 per cent coupon. A further S$2.8 billion was offered through syndication in September 2023. Also in 2023, the government announced that S$700 million raised from the first sovereign issuance would be allocated to finance local rail networks.

ii Sustainability fixed income securities and SLBs

Sustainability bonds are debt securities whose proceeds are exclusively used for a mix of green and social projects, based on specific issuance principles or guidelines. Issuers may voluntarily comply with the Sustainability Bond Guidelines by the ICMA or other standards set by the issuer.

Sustainability-linked bonds (SLBs) are performance-based instruments that vary based on the achievement of predefined sustainability performance targets (SPTs), such as a variable coupon rate linked to defined targets. SLB proceeds can be used for general corporate purposes. The ICMA's Sustainability-Linked Bond Principles provide structuring, disclosure, and reporting guidelines. SLBs offer transition finance for more issuers, including those in hard-to-abate sectors. Unlike green bonds, which must be allocated directly to eligible green projects, SLBs can be applied to support transition plans or meet decarbonisation benchmarks.

Sustainability performance targets (SPTs) can sometimes be selectively applied by issuers, potentially creating credibility issues. To mitigate these risks, issuers may benchmark against target frameworks developed by third parties, such as the Climate Bonds Standard (now in its 'Version 4.0') developed by the Climate Bonds Initiative (an international non-profit).[9]

The SGX launched the Sustainable Fixed Income Initiative to support the development of a sustainable finance ecosystem. It recognises fixed income securities listed on SGX-ST that meet green, social, or sustainability standards. To qualify and maintain their status, issuers must meet certain criteria, release post-issuance reports, disclose significant developments impacting compliance with the recognised standards and make all these publicly accessible. Issuers can use the recognition to demonstrate their commitment to the recognised standards, and to raise their visibility and profile with investors that are interested in sustainable fixed income.[10]

iii Transition finance

Transition bonds are debt securities whose proceeds fund the transition towards reduced environmental impact or carbon emissions. Despite limited investor uptake due to concerns about unclear standards and potential for 'business as usual' practices, the MAS is focused on developing transition finance. It plans to include transition bonds and loans in its sustainable bond and loan grant schemes, with safeguards to prevent 'transition-washing' and ensure alignment with internationally recognised taxonomy and transition finance principles. To encourage transparency, the MAS will incentivise early adoption of entity-level sustainability disclosures by issuers or borrowers. It has allocated S$15 million until 2028 for these enhanced grant schemes. However, transition bonds and loans are still a nascent sector and currently make up only 0.5 per cent of the global sustainable bond market, primarily due to the lack of definitional certainty around what constitute eligible transition activities.

iv Blended finance

Blended finance, which combines public and private capital, can improve return profiles or eliminate risk from projects by distributing concessional capital. It can mobilise financing for marginally bankable projects and potentially unlock capital needs for net zero. The MAS has suggested that unconventional sources such as philanthropic capital, which is resilient and adaptable to repayment and risk absorption limits, could play a significant role if deployed through blended finance mechanisms.

v Insurance-linked securities

The MAS is developing Singapore as a hub for climate risk financing instruments, such as catastrophe bonds, to bolster the insurance sector's disaster risk financing. Since its 2018 launch, the MAS' Insurance Linked Securities (ILS) Grant Scheme has supported 23 catastrophe bonds in Singapore. Notable transactions include the International Bank for Reconstruction and Development's (IBRD), the first Asian sovereign catastrophe bond covering earthquake and typhoon risks in the Philippines, and Akibare Re Pte Ltd's first Asian catastrophe bond covering typhoon and flood risks in Japan, both of which are listed on the SGX.

In April 2023, the MAS extended the Insurance Linked Securities (ILS) Grant Scheme for two more years, until the end of 2025. The scheme's coverage was also expanded to include reinsurance sidecars and collateralised reinsurance arrangements.

vi Social and governance-focused sustainable finance

Singapore's sustainable finance market is primarily focused on the environmental 'E' in 'ESG', with less uptake of social and governance-related instruments. Social bond issuances in ASEAN were sparse in 2022, with only one deal issued by Thailand's Government Savings Bank.

The SGX defines social bonds as debt securities whose proceeds are exclusively used for projects aimed at improving social outcomes, based on specific issuance principles or guidelines. Social bond issuers may voluntarily adhere to the ICMA's Social Bond Principles or other custom frameworks.

Sustainable disclosure requirements and taxonomy

i Banks, insurers and asset managers

The MAS Guidelines for Environmental Risk Management mandate annual disclosure of environmental risk management strategies and the impact of significant environmental risks by banks, asset managers, and insurers. These disclosures must align with respected international reporting frameworks.

With effect from 1 January 2023, authorised or recognised schemes with names implying a focus on ESG-related matters as key investment focus and strategy are required to disclose and comply with the definitions of an ESG fund set out in the circular released by the MAS. This is to alleviate the risks of greenwashing by setting out guidelines on how current requirements under the Code on Collective Investment Schemes (CIS Code) and the Securities and Futures (Offers of Investments) (Collective Investment Schemes) Regulations (SF(CIS)R) pertain to ESG funds.

ii SGX-listed entities

The SGX requires entities listed on the Exchange to release an annual sustainability report on a 'comply or explain' basis. Currently, the SGX recommends that issuers give priority to globally-recognised reporting frameworks for their sustainability-related disclosures.

Although these disclosures are currently required on a 'comply or explain' basis, the SGX is mandating reporting by sector in phases. From 2023 onwards, listed companies in the financial, agriculture and energy industries have been required to provide a climate-related disclosure. Likewise, after 2024, listed entities in the materials and building industry and transportation industry will be required to disclose their climate-related information.

The Accounting and Corporate Regulatory Authority (ACRA) and Singapore Exchange Regulation (the SGX RegCo) launched a public consultation by the Sustainability Reporting Advisory Committee (SRAC), which recommended listed issuers to lead the way and report ISSB-aligned climate-related disclosures (CRDs) from 2025, with large non-listed companies with annual revenue of at least S$1 billion to follow in 2027.

iii Singapore-incorporated companies

There is currently no overarching sustainability reporting requirement for Singapore-incorporated companies, although the ACRA and SGX RegCo established a Sustainability Reporting Advisory Committee to advise on a sustainability reporting roadmap for Singapore-incorporated companies.

iv Singapore–Asia Taxonomy

Singapore has completed the final consultation phase of establishing a taxonomy (the Singapore–Asia Taxonomy). MAS has released two working drafts of the Singapore–Asia Taxonomy for public consultation. Phase 1 of the Singapore–Asia Taxonomy covered five core sectors that account for 90 per cent of ASEAN's greenhouse gas emissions – agriculture and forestry/land use, real estate, transportation, energy and industrial – and three enabling sectors whose products and services contribute to climate change mitigation – information and communications technology, waste/circular economy and carbon capture and sequestration.

Phase 2 of the Singapore–Asia Taxonomy laid out a guiding framework for green and transition activities and the technical screening criteria in three core sectors – energy, buildings and construction, transportation and fuels. Similar guiding frameworks and technical screening criteria for the remaining five sectors are expected in the subsequent phases of the Singapore–Asia Taxonomy. The final Singapore–Asia Taxonomy is planned to be released by the end of 2023.[11]

The Singapore–Asia Taxonomy aims to provide a common and consistent framework that classifies economic activity and promotes sustainable investments, and it was drafted to be compatible with other taxonomies in order to ensure interoperability, particularly with the EU Taxonomy and the ASEAN Taxonomy. The Singapore–Asia Taxonomy introduces a traffic light model of classifying economic activity:

1. red constitutes harmful activities that are not compatible with the net zero trajectory;
2. amber signals that a sector is moving towards more sustainable practices and facilitating a significant reduction in emissions over time; and
3. green signals that the sector is contributing towards climate change mitigation.

The third consultation established criteria for classifying activities that promote a gradual shift towards net zero. The fourth consultation set standards for phasing out coal-fired power plants (CFPPs), aiming to encourage projects that align with a 1.5C transition pathway by retiring CFPPs early. This is crucial for the Asia-Pacific region's energy transition, where coal contributes to nearly 60 per cent of power generation and about a third of greenhouse gas emissions, and where CFPPs typically have long lifespans.

The Singapore–Asia Taxonomy sets technical screening criteria that apply to the CFPP facility (i.e., facility level) as well as to the CFPP owner (i.e., entity level). The technical screening criteria are aligned to global science-based 1.5C-aligned decarbonisation pathways and take into consideration other guidance, including the ASEAN Taxonomy and the 'The Managed Phaseout of High-Emitting Assets' report by the Glasgow Financial Alliance for Net Zero (GFANZ). The managed phase-out process can be considered aligned with the Singapore–Asia Taxonomy if all the facility and entity level criteria are met.

The ASEAN Taxonomy also applies to Singapore as an ASEAN Member State, and the Singapore–Asia Taxonomy is designed to be consistent with the ASEAN Taxonomy. The ASEAN Taxonomy is not legally binding in Singapore but provides a framework compatible with other taxonomies. This principles-based approach is crucial for educating the market, aligning sustainability metrics and disclosure standards across ASEAN and can lay the groundwork for future regulatory initiatives.

ESG data, ratings and reporting

i Mandatory TCFD-aligned disclosures

As discussed in Section V, SGX has confirmed implementation of a roadmap for mandatory disclosure aligned to the TCFD recommendations. Since 2022 all issuers on the SGX have been required to adopt TCFD-aligned reporting on a 'comply or explain' basis. Disclosure then became mandatory in 2023 for companies in key industries, including finance and transportation, and will become mandatory in most other industries in 2024. MAS estimates that by 2025, mandatory climate reporting will cover 60 per cent of SGX-listed entities by number, and 78 per cent by total market capitalisation.

Issuers should accordingly provide climate-related disclosures that are in line with TCFD recommendations, as climate-related risks and opportunities may impact the issuer's future financial standing and performance.

ii ESG metrics reporting

The SGX also recommends a list of 27 core ESG metrics for issuers to use as a starting point for sustainability reporting. These core ESG metrics are intended as a common and standardised set of ESG metrics, which will help better align users and reporters of ESG information. The SGX may review and revise the core ESG metrics periodically, in line with the evolution of international reporting standards. The environmental metrics include measurements of greenhouse gas (GHG) emissions, energy consumption, water consumption and waste generation. The recommended social metrics include gender diversity and age diversity, while the governance metrics include board composition and management diversity.

Companies required to undertake mandatory climate reporting should obtain external assurance on GHG Scope 1 and Scope 2 emissions from fiscal year 2027 for all listed issuers and from fiscal year 2029 for large non-listed companies. This assurance can be provided by ACRA-registered audit firms and testing, inspection, and certification firms accredited by the Singapore Accreditation Council.[12]

iii Project Greenprint

The MAS and SGX have launched ESGenome under Project Greenprint, a digital portal for SGX-listed companies to efficiently report ESG data and for investors to access this data in a consistent, comparable format. The lessons from ESGenome will be used to address the reporting needs of a broader range of Singapore corporates, particularly SMEs, and supply chain partners. Further, a collaboration between the Secretariat of the Climate Data Steering Committee (CDSC), MAS and the SGX aims to synergise data across the ESGenome disclosure portal and the CDSC's Net-Zero Data Public Utility (NZDPU) global repository of climate transition-related data. It will allow companies that report into ESGenome to transmit their data on Scope 1, 2 and 3 GHG emissions to the NZDPU. This will enhance tracking of companies' climate commitments and provide them with access to the NZDPU's global database to support their decarbonisation efforts.

Additionally, as part of Project Greenprint, the MAS introduced ESGpedia, a blockchain-based registry platform providing ESG data from various sectors in one place. This registry records and maintains the provenance of green certifications, aiding banks in their green and sustainable financing decisions.

Sustainable finance incentives

The MAS' Green Finance Steering Committee oversees all green finance and sustainability initiatives. Key government-supported sustainable finance incentives include the GSLS and SBGS. The GSLS, in two tracks, facilitates corporate access to green and sustainability-linked loans and encourages banks to develop similar loan frameworks for SMEs and individuals. It incentivises banks and corporates to invest in sustainable projects by subsidising the costs of independent assessment and advisory services for developing frameworks and reporting on sustainable loan proceeds. The SBGS offsets additional costs for external reviews of eligible green, social, sustainability matters, and SLBs, promoting the adoption of internationally accepted standards.

The MAS has also earmarked S$50 million out of S$250 million from the Finance Sector Technology and Innovation Scheme to support green fintech solutions and projects. This

MAS-administered scheme provides support for the creation of a vibrant ecosystem for innovation in the finance sector.

The MAS announced in 2023 that it will be setting aside a total of S$15 million to enhance and extend the sustainable bond and loan grant schemes to support transition instruments until 31 December 2028.

Carbon markets and carbon trading

One of the government's primary methods to achieve Singapore's net-zero goal is through raising carbon taxes.[13] There is thus a need to source credible and high-quality carbon credits and develop well-functioning and regulated carbon markets.

Climate Impact X (CIX), a Singapore-based global carbon exchange, aims to expand the voluntary carbon market. CIX uses satellite monitoring, machine learning, and blockchain to improve the transparency and quality of carbon credits. In 2023, it launched a spot trading platform to increase transparency and price certainty. CIX introduced the first daily on-exchange liquidity window in the voluntary carbon market with firm bids and offers. A dedicated 30-minute pricing session, pooling liquidity from Asia, Europe and the Middle East, helps refine benchmark prices and enhance order depth for spot nature-based credits. CIX's Marketplace is a platform for businesses and carbon project suppliers to list, compare, buy and retire verified carbon credits.

Green technology

i Overview

The government recognises that technology and sustainability are two fundamental forces shaping the future of financial services. One of the MAS' key strategies, therefore, is to harness Singapore's strength in fintech to address challenges in the green finance space. In addition, the government continues to invest in green technology. For example, Temasek (a state-owned holding company) committed an initial amount of S$5 billion to establish GenZero, an investment platform that aims to accelerate decarbonisation for future generations towards a net zero world. GenZero will invest globally across three focus areas: technology-based solutions, nature-based solutions and carbon ecosystem enablers. In September 2023, DBS Foundation and Temasek Trust launched Co-Axis, a technology-based platform that will connect funders, such as family offices, corporate entities and private foundations, to businesses for impact or social enterprises, charitable organisations and blended finance projects to pursue impact-focused opportunities.

ii Climate fintech

One prominent form of technology driving sustainable finance adoption is climate-related fintech. The MAS runs a Global FinTech Hackcelerator, in which fintech firms and solution providers around the world are invited to submit innovative solutions to address over 50 problem statements collected from financial institutions and industry partners. The green finance problem focuses on enhancing investor and financial institutions' ease of monitoring commitments and measuring impact of loans and investments against its sustainability goals[14]. Temasek Trust ecosystem entities – the Centre for Impact Investing and Practices and Philanthropy Asia Alliance – are launching also the Amplifier, a mentorship programme aiming to catalyse impact ventures to deliver positive change at scale.

iii Energy storage systems

To tackle solar intermittency and enhance grid resilience and reliability, in 2023 Sembcorp Industries and the Energy Market Authority (EMA) launched the largest energy storage system in Southeast Asia, which produces 285 megawatt-hours of energy.[15]

iv National Hydrogen Strategy

Singapore is exploring emerging low-carbon alternatives such as hydrogen, geothermal and carbon capture, utilisation and storage. The National Hydrogen Strategy seeks to explore how to develop hydrogen as a major decarbonisation pathway. Hydrogen can complement and diversify Singapore's current power mix of solar, imported electricity and other potential low-carbon energy sources such as geothermal energy[16]. However, there remain significant logistical and technological developments required for such promise to be realised.

Climate change, nature and biodiversity impacts

i Carbon tax

Under the carbon tax policy, businesses emitting at least 25,000 tCO_2e annually must register as a taxable facility and meet annual NEA reporting requirements through an emissions monitoring system. Non-compliance can result in fines or imprisonment, depending on the violation's severity. An increased carbon tax may stimulate more carbon trading to offset emissions, potentially leading to contractual disputes over issues like commodity non-delivery and breaches of covenants and warranties.

ii Climate reporting and disclosure requirements

As outlined in Sections V and VI, MAS has issued environmental risk management guidelines for banking, insurance and asset management. The MAS and SGX have also established roadmaps for mandatory, 'legally binding' climate-related financial disclosures by financial institutions and listed entities, implemented in phases after industry consultation. The enforcement of mandatory climate reporting could potentially increase climate litigation over insufficient disclosures and breaches of directors' duties.

iii Hydrofluorocarbon (HFC) mitigation measures

In 2019, the NEA introduced measures to reduce HFC emissions by implementing licensing controls on HFCs aimed at establishing a better national consumption baseline level.

Recent amendments to the Environmental Protection and Management Act, passed in 2022, will also provide additional regulatory enforcement powers to NEA to control the release of HFCs through its existing initiatives.

iv Waste mitigation measures

The Singapore government amended the Resource Sustainability Act 2018 in March 2023.[17] The amendments seek to reduce packaging and food waste by, among other things, imposing a charge on disposable plastic bags and encouraging recycling.

v Arbitrating climate disputes

Renewable investments increasing in Southeast Asia is likely to lead to more international commercial disputes. Regional parties commonly include clauses in contracts requiring arbitration of disputes in Singapore, often before the Singapore International Arbitration Centre (SIAC). Investments made through Singapore-incorporated companies could also result in more investor–state arbitrations in Singapore due to changes in governmental environmental regulations, which could in turn lead to uncompensated expropriation and unfair or inequitable treatment.

Greenwashing and climate litigation risks

i Greenwashing

The Singapore Consumer Protection (Fair Trading) Act 2003 (CPFTA) protects consumers against false or misleading claims, including those related to greenwashing. The Singapore Code of Advertising Practice, developed by the Advertising Standards Authority of Singapore, also ensures that advertisers clearly explain and substantiate any environmental claims. The CPFTA is administered by the Competition and Consumer Commission of Singapore (CCCS), and the CCCS appears to be the most logical agency to have oversight over the development of any greenwashing regulations. To date there are no specific regulations on greenwashing, and the CCCS has not received specific complaints of greenwashing. However, the government has indicated that it will continue to monitor developments and determine if further measures may be necessary.

As noted in Section V, retail ESG funds are subject to enhanced disclosure requirements designed to mitigate the risk of greenwashing, while the evolution of Singapore's climate disclosures regime noted in Section V is also in part a response by the government to ensure that greenwashing is combated in order to enhance the credibility of Singapore's sustainable finance markets.

ii Climate change litigation and enforcement actions

There are no reported cases of climate-related litigation by private parties in the Singapore courts at the time of writing. The lack of litigation may be due to various factors.

First, unlike its neighbours Hong Kong, Malaysia and Australia, Singapore lacks a formal environmental impact assessment (EIA) law requiring development projects to prioritise environmental considerations. At present, individual ministries decide, based on their internal guidelines, whether an EIA is necessary for certain projects. There are also no statutory requirements that EIAs are published for public review. Without an EIA law in place, there are no formal avenues for the public to commence climate change litigation in the Singapore courts.

Second, given that most climate change issues affect the public at large, a climate change action would usually have to be brought via representative proceedings under Order 15 Rule 12 of the Singapore Rules of Court. Such proceedings, however, are rare, as they subject the litigant to many procedural hurdles before an action can be commenced.

Third, it is difficult for a company's shareholders to sue its directors for failing to adequately address climate-related risks. Singapore law does not impose any express obligation on company directors to take climate-related risks into account. Rather, directors owe a duty to act in good faith in the company's best interests. A shareholder would therefore need to show that the directors' failure to address climate-related risks had a foreseeable and material impact on the interests of the company, which presents a significant evidentiary hurdle for potential shareholder plaintiffs.

While private actions to enforce climate-related obligations remain scarce in Singapore, there are nonetheless other avenues to facilitate and enforce Singapore's carbon emissions targets, including through the implementation by public authorities of various laws and regulations that carry penalties for non-compliance.

The evolving legal and regulatory environment in Singapore might also be a source of potential climate change disputes, as new laws and regulations lead to additional causes of action.

Outlook and conclusions

The trend in sustainable finance regulation is shifting from voluntary measures towards more regulatory intervention and stronger enforcement by regulators. As Singapore aims to be a global leader in green and sustainable finance, the government and its regulators are likely to continue to develop policies and regulations to reflect this ambition. Actions in this direction already include implementing the Singapore–Asia Taxonomy, developing regulations, frameworks, and standards to prevent greenwashing and to boost investor confidence and enhancing environmental and climate-related disclosure standards for market transparency. The integrity of carbon credits and markets will continue to be refined, and transition finance will play an increasingly key role as hard-to-abate sectors strive for net zero emissions.

Endnotes

1 Timothy Goh and Thomas Kim are partners and David Good is a senior associate at Dechert LLP. The authors would like to thank Drew Singer, Shawn Yeo, Daniel Gaw, Therese Ang and Katriel Loh for their assistance in drafting this chapter. ^ Back to section

2 Singapore announced in its 2022 budget that it would review its 2030 nationally determined contribution, which currently pledges to achieve peak emissions at 65 MtCO2e around 2030. See also Singapore's Green Plan 2030, which sets a framework of targets to strengthen Singapore's commitments under the Paris Agreement and the UN's 2030 Sustainable Development Agenda. ^ Back to section

3 One of the key strategies outlined in Singapore's Financial Services Industry Transformation Map 2025 is to catalyse Asia's net-zero transition. According to the Map, the MAS will work with finance industry stakeholders to develop innovative solutions to scale up sustainable and transition financing through the following: providing greater clarity on transition activities including through the development of an industry-led taxonomy for eight priority sectors; facilitate the decarbonisation of 'real economy' sectors through appropriate financing solutions for corporates; enhance sustainability disclosures and build data utilities, such as Project GreenPrint, to facilitate companies' sustainability disclosures and investors' access to companies' ESG data; and provide S$100 million grant funding from 2021 to 2025 for capability building, green fintech, climate risk and reinsurance and solutions for sustainable and transition finance. ^ Back to section

4 MAS Guidelines for Environmental Risk Management (Banks), p. 6; MAS Guidelines for Environmental Risk Management (Insurers), p. 6; MAS Guidelines for Environmental Risk Management (Asset Managers), p. 5. ^ Back to section

5 MAS Guidelines for Environmental Risk Management (Banks), pp. 6–7; MAS Guidelines for Environmental Risk Management (Insurers), p. 6; MAS Guidelines for Environmental Risk Management (Asset Managers), pp. 7–8. ^ Back to section

6 MAS issued Circular No. CFC 02/2022 on disclosure and reporting guidelines for all retail ESG funds. See https://www.mas.gov.sg/regulation/circulars/cfc-02-2022---disclosure-and-reporting-guidelines-for-retail-esg-funds. ^ Back to section

7 Joint news release between NEA and MSE: Singapore Sets Out Eligibility Criteria For International Carbon Credits Under The Carbon Tax Regime: https://www.nea.gov.sg/media/news/news/index/singapore-sets-out-eligibility-criteria-for-international-carbon-credits-under-the-carbon-tax-regime. ^ Back to section

8 ASEAN Sustainable Finance: State Of The Market 2022: https://www.climatebonds.net/files/reports/cbi_asean_sotm_2022_02f.pdf. ^ Back to section

9 https://www.climatebonds.net/climate-bonds-standard-v4. ^ Back to section

10 https://www.sgx.com/fixed-income/sustainable-fixed-income. ^ Back to section

11 Green Finance Industry Taskforce: Cultivating Singapore's Sustainable Finance Ecosystem to support Asia's transition to Net-Zero: June 2023: https://www.mas.gov.sg/-/media/gfit-publication_june_2023.pdf. ^ Back to section

12 https://www.sgx.com/regulation/public-consultations/20230706-consultation-paper-recommendations-sustainability. ^ Back to section

13 The carbon tax will be raised to S$25/tCO2e in 2024 and 2025, and S$45/tCO2e in 2026 and 2027, with a view to reaching S$50-80/tCO2e by 2030. ^ Back to section

14 https://www.mas.gov.sg/news/media-releases/2022/mas-launches-2022-global-fintech-hackcelerator-on-web-3-0-and-green-finance. ^ Back to section

15 https://www.sembcorp.com/en/media/media-releases/energy/2023/february/southeast-asia-s-largest-energy-storage-system-officially-opens/. ^ Back to section

16 MTI: Singapore's National Hydrogen Strategy: https://www.mti.gov.sg/Industries/Hydrogen. ^ Back to section

17 Resource Sustainability (Amendment) Act 2023. ^ Back to section

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Introduction

The fight against climate change entails a number of important challenges for both society and the economy. Reaching the targets set out by international, European and national instruments requires the economy to become carbon neutral. To this end, the financial system is crucial to reorient capital flows towards more sustainable economic activities and in developing sustainable financing instruments to transform the economy. Sustainable finance aims at incorporating environmental, social and governance elements into business management and investment decision-making.

The framework for climate action in Spain follows both the commitments assumed under the Paris Agreement (ratified by Spain on 22 April 2016) and the European Union's energy and climate policy. Thus, Spain is committed to limit global warming to well below 2°C, and is following the path of the European Union and its European Green Deal, which aims to make Europe the first climate-neutral continent by 2050. The greenhouse gas emissions reduction target at a European level has been recently revised to 55 per cent by 2030, compared to 1990 levels. The European Commission has presented the Fit for 55 package, which is a set of proposals to revise and update EU legislation on climate and energy with the aim of ensuring the climate goals.

In this context, Parliament passed Law No. 7/2021 of 20 May, on Climate Change and Energy Transition (Climate Change Act), which aims, among other objectives, to ensure Spain's compliance with the objectives of the Paris Agreement, and has introduced relevant sustainable disclosure requirements. Even though Spain has been promoting conditions to encourage sustainable economic development at least since Law 2/2011, of 4 March, on Sustainable Economy, sustainable finance has gained more momentum in recent years, as a clear trend to reallocate resources towards sustainable investments can be identified in the market. In parallel, a reverse trend is underway aimed at cutting the financing of projects that are not sustainable. Therefore, a legal framework is being developed (at an international, European and domestic level) that is accompanying this tendency, which ultimately aims to secure the transition to a carbon neutral economy by 2050.

To allocate resources to genuinely sustainable projects, it is necessary to standardise criteria and provide transparency. Environmental taxonomy has thus become a crucial factor
that enables a classification system and the unification of criteria on activities, assets or revenue segments that deliver on environmental objectives.

Year in review

In recent years, and following the launch of the European Commission's sustainable finance action plan (SFAP) in 2018, the European Union has issued a number of regulations on sustainable finances (which are identified in the following section) that are directly applicable to operators of the Spanish market. To implement such EU regulations properly, in June 2021, the national supervisory body, the Spanish National Securities Market Commission, issued a guidance document, providing criteria on the application of EU sustainability regulations to financial products in Spain.

At a national level, the Climate Change Act has established a general framework to promote sustainable investments, which includes some reporting obligations for financial operators. Its provisions will be further developed in the coming years. As a preliminary step, the Ministry of Economic Affairs and Digital Transformation is currently preparing a national plan for sustainable finances. The strategic objectives of this plan are:

1. to ensure the transformation of the public and private financial sector towards a model aligned with climate neutrality, while preserving its viability and financial stability;
2. to improve the competitiveness of the Spanish financial sector; and
3. to redirect capital flows towards a low carbon and more sustainable investment economy.

This plan is expected to include actions such as the regulatory development on sustainable finance provisions of the Climate Change Act.

A relevant milestone of the past year has been the implementation of the green bond programme of Spain, which led to the issuance of a 21-year, €5 billion green bond by the Treasury in September 2021. Following this issuance, the government is promoting the issuance of green bonds by private institutions.

Regulation and policy

i Governance regime

Spain is a party to all relevant international treaties, such as the UNFCCC, the Kyoto Protocol and the Paris Agreement. Spain is also an EU Member State. Therefore, the Spanish internal regulations are highly influenced by international and European regulations and objectives.

The SFAP's main aim is to reorient capital flows towards more sustainable economic activities, promoting the transformation of the productive sector into a more environmentally sustainable one. The SFAP is being implemented through a series of EU regulations on sustainable finance on:

1. taxonomy;[2]
2. sustainability benchmarks;[3] and
3. disclosure obligations for financial market participants and advisers,[4] and financial entities, listed and unlisted companies and large unlisted companies,[5] as regards corporate sustainability reporting.

Since the ratification by Spain of the Paris Agreement on 22 April 2016, a number of regulatory initiatives have been developed to integrate environmental, social and governance considerations into investment decision-making, with the ultimate goal of transitioning to a low-carbon, circular and sustainable economy. The main regulations containing provisions on sustainable finances are:

1. Law No. 7/2021, of 20 May, on Climate Change and Energy Transition. This Law plays a pivotal role in the Spanish legal system with respect to the fight against climate change. From a cross-cutting approach, it provides the regulatory framework to ensure compliance with the aim of decarbonisation of the Spanish economy by 2050.
2. Law No. 11/2018, of 28 December, amending the Commercial Code, the Consolidated Text of the Law on Corporations, and Law on Audit of Accounts, with regard to non-financial information and diversity.[6]
3. Law No. 2/2011, of 4 March, on Sustainable Economy (as amended, in particular, by Royal Decree-Law No. 36/2020, of 30 December).

ii Regulators

The Spanish finance market is subject to supervision by different international regulators. Some of the most active fora are the Network for Greening the Financial System (which comprises 100 members) and the Basel Committee on Banking Supervision. At an EU level, the main regulators are the European Commission and the European Central Bank.

Besides international regulators, the main national supervisors are the Ministry of Economic Affairs and Digital Transformation, the Spanish National Securities Market Commission, the Bank of Spain, the Directorate General of Insurance and Pension Funds and the Climate Change Office. All these institutions collaborate and have competences in the field of sustainable finance.

Sustainable finance instruments

Spain is committed under the Paris Agreement to bring 'finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development' (Article 2.1.(c)). To this end, the country is designing the legal framework to promote sustainable investment, enabling capital flows to be reallocated towards sustainable and inclusive growth. The Climate Change Act lays the foundations to do so.

In particular, the government is working on a national sustainable finance plan (see Section II). Among other actions, the draft of the plan foresees the creation of a mixed investment fund (public and private) for the financing of sustainable projects, or the adaptation of the financial system to the use of the taxonomy of sustainable finance.

While such provisions are being developed, as previously mentioned, in September 2021, the Treasury issued a 21-year, €5 billion green bond, the first sovereign green bond of Spain. This issuance proved very successful with investors, and is aimed at financing sustainable positions in the national budget. Alongside it, the national government recognises that it will not be able to mobilise the levels of investment required to decarbonise the economy on its own, and is encouraging private sector participation in the issuance of green bonds.

Apart from green bonds, additional financing instruments are already in place.

In 2009, the carbon fund for sustainable economy (FES-CO2) was created as a climate finance instrument. Among other actions, it acquires carbon credits, preferentially on energy efficiency, renewable energy and waste management projects. Its specific rules are regulated in Royal Decree No. 1494/2011, of 24 October, which regulates the carbon fund for a sustainable economy.

Similarly, the ecological restoration and resilience fund was created in 2020. This fund aims to support, mainly through the award of public subsidies, actions in the areas of water, coasts, climate change and pollution prevention as part of the recovery, transformation and resilience plan (implementation in Spain of the NextGenerationEU recovery plan). The fund was created through Royal Decree-Law No. 6/2020 of 30 December, approving urgent measures for the modernisation of the public administration and for the implementation of the recovery, transformation and resilience plan.

The Spanish National Promotional Bank (ICO) provides direct financing to sustainable projects. The ICO has been accredited by the European Commission to manage funds from the Invest EU programme for the period 2021–2027 (which plans to allocate €26.2 billion in guarantees in all Member States).

On the other hand, in order to comply with Spain's international climate finance commitments, the Climate Change Act also requires the national government to:

1. develop a plan for the entire Spanish public sector to divest holdings or financial instruments in companies or entities whose business activity includes the extraction, refining or processing of fossil energy products; and
2. establish an international climate finance strategy (to date, not yet implemented).

Within the framework of green financing, social and governance aspects are also taken into consideration in order to achieve a just transition. One of the major objectives of the Climate Change Act is, indeed, to promote adaptation to the impacts of climate change and the implementation of a sustainable development model that generates decent employment and contributes to the reduction of inequalities.

Sustainable disclosure requirements and taxonomy

i Sustainability-related disclosures in financial services

Being part of the European Union, and with the ultimate aim of mobilising capital in the financial sector towards more sustainable entities, EU No. Regulation 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector applies to financial market participants and advisers in Spain. It provides harmonised transparency rules in investment and advisory decision-making processes.

Financial market participants must communicate to investors how they have considered sustainability objectives (in environmental and social terms) in their investment decision-making. Emphasis should be placed on a pre-contractual duty of disclosure, which includes a description of how sustainability risks are integrated into investment decisions and the results of the assessment of the potential impact of sustainability risks on the profitability of the financial products they offer. In addition, a clear and reasoned explanation of how the financial product has considered the main adverse impacts on sustainability factors should also be provided.

ii EU taxonomy for sustainable activities

The proper allocation of funds towards sustainable projects demands the development of a classification system, establishing a list of environmentally sustainable economic activities. To this end, Action 7 of the European Commission's SFAP on financing sustainable growth (March 2018) identified a need to clarify the obligations of institutional investors and asset managers in relation to sustainability factors.

This requirement resulted in the Taxonomy Regulation,[7] which governs taxonomy for environmentally sustainable economic activities, as it provides for a common language and a clear definition of what 'sustainable' is. Taxonomy is a classification system that provides economic operators with unified standards and criteria to consider certain economic activities and investments as environmentally sustainable.

In addition, this EU Regulation obliges financial market participants (asset managers, institutional investors, entities offering certain financial products, among others) to publish how they consider sustainability factors and risks in their strategies and investment decisions.

ESG data and reporting

i Disclosure of environmental matters on the non-financial statement of the annual accounts

The Spanish legal system does not contain specific regulations on the environmental matters related with their activity that companies must disclose. Certain companies are obliged to disclose information on environmental matters to be included in their annual accounts.

In particular, companies obligated to prepare a non-financial statement (NFS) as part of the management report of the annual accounts must include significant information on environmental issues. A company shall prepare the NFS (either consolidated at a group level, or individual):

1. if the number of employees exceeds 250; and
2. the company is classified as a public interest entity in accordance with THE Law on Audit of Accounts, or for two consecutive financial years the company's total assets are greater than €20 million or the net annual turnover exceeds €40 million.

According to Article 49.6.I of the Commercial Code (approved by Royal Decree of 22 August 1885), such information shall be:

1. the current and foreseeable effects of the company's activities on the environment and, where appropriate, on health and safety;
2. the environmental assessment or certification procedures;
3. the resources assigned to the prevention of environmental risks;
4. the application of the precautionary principle; and
5. the amount of provisions and guarantees covering environmental risks.

In addition, specific information concerning the following areas must also be provided:

1. Emissions: measures taken to prevent, reduce or remediate carbon emissions that have a significant impact on the environment; any kind of atmospheric pollution from an activity must be considered.
2. Circular economy and waste prevention and management: waste prevention, recycling and reuse measures adopted, and other forms of waste recovery and disposal implemented.
3. Sustainable use of resources: water usage and water supply in accordance with local constraints; consumption of raw materials and measures taken to improve the efficiency of their use; direct and indirect energy consumption, measures taken to improve energy efficiency and the use of renewable energies.
4. Climate change: the significant factors of greenhouse gas emissions generated as a result of the company's activities, including the use of the goods and services it produces; the measures taken to adapt to the consequences of climate change; the reduction targets voluntarily set in the medium and long term to reduce greenhouse gas emissions and the measures implemented to this end.
5. Biodiversity protection: measures taken to preserve or restore biodiversity; impact caused by activities or operations in protected areas.

ii Report on the financial impact assessment of the risks associated with climate change for the company

Article 32 of Law No. 7/2021 of 20 May, on Climate Change and Energy Efficiency has introduced an obligation for certain companies to submit, as part of their non-financial reporting obligations, an annual report assessing the financial impact on the company of the risks associated with climate change caused by the exposure of its activity to climate change, including the risks of the transition to a sustainable economy and the measures adopted to address these financial risks.

The following companies must report on the financial impact of the risks associated with climate change on the company:

1. Companies issuing securities admitted to trading on regulated markets that prepare consolidated annual accounts, as well as those that are not part of a consolidable

group and have the obligation to include either a consolidated or an individual NFS in the management report.

2. Consolidated groups of credit institutions and credit institutions not included in one of these consolidated groups subject to the supervisory regime of the Banco de España and the European Central Bank, in accordance with the provisions of Regulation (EU) No. 1024/2013.
3. Consolidated groups of insurance and reinsurance companies, and insurance and reinsurance companies that are not part of one of these groups, are subject to the supervisory regime of the Directorate General of Insurance and Pension Funds.
4. Companies preparing consolidated accounts, and companies that do not form part of a consolidable group (other than those referred to in the previous sections) that have the obligation to include either a consolidated or an individual NFS in the management report.

Companies must provide, at least, the following information in the annual report:

1. The governance structure of the company, including the role of its different bodies, in relation to the identification, assessment and management of risks and opportunities related to climate change.
2. The strategic approach, in terms of both adaptation and mitigation, of the entities to manage the financial risks associated with climate change, taking into account the risks already existing at the time of writing the report, and those that may arise in the future, identifying the actions required at that time to mitigate such risks.
3. The actual and potential impacts of climate change risks and opportunities on the company's activities and strategy, as well as on its financial planning.
4. The processes for identifying, assessing, monitoring and managing climate-related risks and how these are integrated into its overall business risk analysis and their integration into the company's overall risk management.
5. The metrics, scenarios and targets used to assess and manage the relevant risks and opportunities related to climate change and, if calculated, the scope 1, 2 and 3 of its carbon footprint and how its reduction is addressed.

iii Integration of climate change risk into the financial and energy system

Finally, the Climate Change Act also establishes obligations for supervisors regarding the correlation between climate risk management, long-term value creation and market performance. According to Article 33, the Bank of Spain, the Spanish National Securities Market Commission and the Directorate General for Insurance and Pension Funds, within the scope of their respective areas of competence, shall jointly prepare, every two years, a report on the assessment of the risk to the Spanish financial system arising from climate change and the policies to fight it.

Sustainable finance incentives

On a general basis, the Climate Change Act establishes, among other things, a general regime for the allocation of public resources to the fight against climate change. By virtue thereof, a percentage of the general state budget, equivalent at least to that agreed in the multiannual financial framework of the European Union, must support the objectives regarding climate change and energy transition. This percentage will be revised upwards by the government before 2025.

The Climate Change Act also includes a series of incentives in relation to public procurement, including the inclusion in the specific administrative clauses of award criteria linked to the fight against climate change and of specific technical conditions setting out the necessary reduction of emissions and carbon footprint.

Finally, the Climate Change Act foresees a tax reform that will assess green taxation. However, due to the rise of energy prices, the government has decided to postpone such reform.

In addition to the foregoing, Spain is part of the EU trade scheme under EU Directive 2003/87/EC implemented in Spain by means of Law 1/2005, of 9 March, governing the greenhouse gas emissions trading scheme. According to this law, obliged parties must obtain a greenhouse gas emission authorisation, which is granted by the autonomous regions, and deliver on an annual basis greenhouse gas emission allowances per each equivalent tonne of carbon dioxide emitted. The current trading period (phase IV) started in January 2021 and will expire on 31 December 2030.

According to the Climate Change Act, revenues from the auctioning of greenhouse gas emission allowances will be used to meet climate change and energy transition goals. The general state budget will allocate at least €450 million each year to finance the costs of the electricity system provided for in the Electricity Sector Act, regarding promotion of renewable energies. Up to 30 per cent of the total revenue may be allocated to measures with social impact to alleviate situations caused by the transition to a decarbonised economy or related to vulnerability to the impacts of climate change.

In 2020, in response to the covid-19 pandemic, the European Council agreed on the exceptional recovery instrument known as NextGenerationEU to address the economic and social consequences of the pandemic. This economic support will be used to promote a green, digital and resilient recovery of the economy, as the pandemic is an extraordinary opportunity to promote ecological transition and the fight against climate change.

The aforementioned regime is completed by several national strategies and plans supporting the fight against climate change and the ecological transition. The most relevant strategies are the just transition strategy, the national climate change adaptation plan 2021–2030, the national integrated energy and climate plan 2021–2030 and the long-term decarbonisation strategy, which sets out a pathway to achieve climate neutrality by 2050.

Green technology

As part of the Spanish recovery, transformation and resilience plan's objective of transforming the Spanish economy, several strategic projects (PERTE) have been approved, among them, a PERTE for renewable energy, renewable hydrogen and storage. In addition, the Ministry for Ecological Transition and the Demographic Challenge is focusing on boosting green hydrogen projects in different regions of the country, and has approved an incentive programme for pioneering and unique renewable hydrogen projects (H2 PIONEERS programme).

The Ministry for Ecological Transition and the Demographic Challenge is also supporting investments in other sustainable technologies, such as green methanol production plants.

Climate change impact

As already mentioned, the Climate Change Act has been recently approved. This law sets the following legally binding targets for 2030:

1. reducing greenhouse gas emissions by 23 per cent compared to 1990 levels;
2. 42 per cent of final energy consumption coming from renewable energy sources;
3. achieve an electricity system with at least 74 per cent of generation from renewable energy sources; and
4. improve energy efficiency by reducing primary energy consumption by at least 39.5 per cent compared to the baseline in accordance with EU legislation.

It is still too early to assess the success in meeting these objectives.

To comply with the information objectives assumed under the Paris Agreement and other international and EU regulations, in accordance with the Climate Change Act, the Ministry for Ecological Transition and the Demographic Challenge, in collaboration with other ministerial departments and the autonomous regions, shall prepare and publish reports, at least every five years, on the evolution of the impacts and risks derived from climate change and on the policies and measures aimed at increasing resilience and reducing vulnerability to climate change in Spain.

Outlook and conclusions

Spain has made the fight against climate change one of its core priorities and is committed to financing more sustainable activities and projects. As already mentioned, the Climate Change Act has recently been passed. While this law has laid the foundations for the regulation of sustainable finance and contains some directly applicable obligations, its provisions on sustainable finance are awaiting further regulatory implementation in the coming years. Therefore, standards on sustainable finance are mainly provided by EU law at the moment, although there have been specific internal developments in the area of non-financial reporting.

The authorities and the Spanish market are taking steps to implement a comprehensive legal regime, which encourages and reorients investments towards sustainable projects, with the ultimate aim of ensuring the transition to a carbon-neutral society and economy.

Endnotes

1 Jesús Sedano Lorenzo is counsel and Luis Villar González is a junior associate at Uría Menéndez Abogados, SLP. The information in this chapter was accurate as at December 2022. ^ Back to section

2 Regulation (EU) No. 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment. ^ Back to section

3 Regulation (EU) No. 2019/2089 of 27 November 2019 amending Regulation (EU) No. 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and Sustainability-related Disclosures for Benchmarks. ^ Back to section

4 Regulation (EU) No. 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector. ^ Back to section

5 Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No. 537/2014. ^ Back to section

6 Which transposes Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups. ^ Back to section

7 Regulation (EU) No. 2020/852. ^ Back to section

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Introduction

Sustainability is becoming more and more important in the Swiss financial sector. Although there is no overarching legislative framework on sustainable finance, various measures have been taken to promote sustainable finance:

The revised Federal Act on the Reduction of CO2 Emissions (the Draft CO2 Act),[2] which has yet to pass the legislative process, provides for an explicit obligation of the Swiss Financial Market Supervisory Authority (FINMA) to review the climate-related financial risks for the financial institutions it supervises on a regular basis. Similarly, the Swiss National Bank (SNB) as per the Draft CO2 Act will regularly have to assess any risks to the stability of the financial system arising from climate change and its mitigation. FINMA has already partially implemented the proposed revision by strengthening climate-risk-related disclosure requirements for large banks and insurance companies in July 2021 on the basis of its general mandate to protect creditors, investors and insured persons as well as the functioning of financial markets in Switzerland (see below). In addition, FINMA has published guidance on preventing and combating greenwashing. In FINMA Guidance 05/2021, FINMA sets out rules on: (1) sustainability-related information for Swiss collective investment schemes (funds); (2) organisational structure of institutions that manage sustainability-related funds; and (3) rules of conduct at the point of sale for sustainability-related products.

On statutory level, the Swiss Code of Obligations (CO)[3] has been amended as of the beginning of 2023 to provide for general reporting and disclosure obligations on non-financial matters (e.g., risks of their business activities regarding environmental matters, social issues, employment issues, human rights and combating corruption), which will be applicable to listed companies, companies supervised by FINMA and other large companies (see below). The relevant implementing ordinance will come into force as of 1 January 2024. Mandatory disclosures under the new ordinance will include reporting on climate-related risks, as well as on the impact of company activities on climate change. Reporting obligations will also include disclosures of all direct and indirect greenhouse gas emissions, as well as emissions reduction targets and on how the companies plan to implement these goals.

Year in review

Following the rejection of a first version of a revised CO2 Act providing for more stringent measures in light of the more ambitious targets under the Paris Agreement by a referendum in June 2021, in December 2021 the Federal Council presented a second draft for a revised CO2 Act with measures for the time period between 2025 to 2030 (the Draft CO2 Act), which is currently being debated in the Swiss parliament. The Draft CO2 Act provides for an explicit obligation of FINMA to review the climate-related financial risks for the financial institutions it supervises on a regular basis (see below).

Effective from 1 January 2022, new reporting requirements for non-financial matters have been introduced in the CO. Listed companies, companies supervised by FINMA and other large companies are required to publish a respective report for the first time for the business year 2023. On 23 November 2022, the Federal Council adopted the implementing ordinance on climate reporting (the Ordinance),[4] which will enter into force as of 1 January 2024.[5] The Ordinance establishes a presumption that the reporting obligations of the companies concerned under Article 964a CO with respect to climate matters are fulfilled if they comply with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

Regulation and policy

i Governance regime

Switzerland is committed to the UN 2030 agenda and sustainable development goals (SDGs) and in June 2021, the Federal Council has adopted its 2030 Sustainable Development Strategy and the corresponding Action Plan 2021–2023 defining three priority themes (sustainable consumption and production; climate, energy and biodiversity; equal opportunities and social cohesion) and a total of 22 implementing measures, respectively. In addition, in December 2022, the Federal Council approved the report on sustainability in the financial sector, focusing on four areas of action (sustainability data from the overall economy, transparency in the financial sector, impact investments and green bonds and pricing pollution). The report sets out 15 measures for the years 2022 to 2025 with the intention of consolidating the Swiss financial centre's position as leading global location for sustainable finance. Switzerland also hosts various sustainable finance organisations, mainly in Geneva, such as the United Nations Environment Programme Finance Initiative (UNEP FI), the World Business Council for Sustainable Development (WBCSD), the Bank for International Settlements (BIS), the Green Digital Finance Alliance (GDFA), the UNDP International Network of Financial Centres for Sustainability (FC4S) and the Financial Stability Board (FSB) to name a few.

Furthermore, Switzerland has ratified the Paris Agreement and aims to reduce its greenhouse gas emissions to net zero by 2050. Switzerland's nationally determined contribution (NDC) under the Paris Agreement is to reduce its greenhouse gas emissions by at least 50 per cent by 2030 compared with 1990 levels, corresponding to an average reduction of greenhouse gas emissions by at least 35 per cent over the period 2021–2030. By 2025, a reduction of greenhouse gases by at least 35 per cent compared with 1990 levels is anticipated.

The primary instrument for achieving Switzerland's carbon emissions reductions targets are measures imposed under the Federal Act on the Reduction of CO2 Emissions (the CO2 Act).[6] However, the CO2 Act as currently in force focuses on measures in the building, transportation and energy sector as well as (other) emissions intensive industries. It does not contain provisions specifically addressing the financial sector. After a first version of a revised CO2 Act providing for more stringent measures in light of the more ambitious targets under the Paris Agreement was rejected in a referendum held in June 2021, the Federal Council presented a second draft for a revised CO2 Act later that year with measures for the time period between 2025 to 2030 (the Draft CO2 Act[7]), which is currently being debated in Swiss parliament.

The Draft CO2 Act provides for an explicit obligation of FINMA to review the climate-related financial risks for the financial institutions it supervises on a regular basis. Similarly, the

SNB as per the Draft CO2 Act will regularly have to assess any risks to the stability of the financial system arising from climate change and its mitigation.[8] FINMA has already partially implemented the proposed revision by strengthening climate-risk-related disclosure requirements for large banks and insurance companies in July 2021 on the basis of its general mandate to protect creditors, investors and insured persons as well as the functioning of financial markets in Switzerland (see below).

In addition, the CO has been amended to provide for general reporting and disclosure obligations on non-financial matters (e.g., risks of their business activities regarding environmental matters, social issues, employment issues, human rights and combating against corruption)[9] which are applicable to listed companies, companies supervised by FINMA and other large companies as of 1 January 2023 (see below). In addition, in implementation of Measure 17 of the Action Plan 2021–2023 to its Sustainable Development Strategy, the Federal Council has issued an ordinance detailing the disclosure obligations of the aforementioned companies on climate matters on the basis of the recommendations of the TCFD.[10] The ordinance will enter into force on 1 January 2024 (also see below).

ii Regulators

In Switzerland, FINMA is tasked with the supervision of market participants such as banks, insurance companies, securities firms, financial market infrastructures, collective investment schemes and (other) financial service providers as well as the enforcement of financial markets regulations including the sector-specific disclosure obligations. However, in the absence of a specific binding sustainable finance framework, FINMA's leeway to issue (binding) regulatory guidance is limited.

Nevertheless, Swiss financial market authorities and governmental bodies are actively contributing to the development of ESG-related soft law in various international organisations. For example, both FINMA and SNB are part of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS),[11] and in 2021 Switzerland joined the TCFD, which was founded by the FSB to improve and increase reporting of climate-related financial information.

Further recommendations and self-regulation in the area of sustainable finance have been issued in the last two years by the Asset Management Association Switzerland (AMAS), the Swiss Bankers Association (SBA) and Swiss Sustainable Finance (SSF). However, in October 2023 the Federal Department of Finance (FDF) announced that it will draw up a proposal for principles-based regulation to prevent greenwashing at ordinance level, indicating that it deems the self-regulatory efforts undertaken so far insufficient to provide adequate protection.[12]

Sustainable finance instruments

i General trends regarding sustainable finance in Switzerland

Based on a market study prepared by Swiss Sustainable Finance (SSF),[13] taking sustainability matters into investment questions has become an overall trend in Switzerland

and sustainable investments (including sustainable funds, sustainable mandates and sustainable assets).

Sustainable funds currently represent about 52 per cent of the overall Swiss fund market. Around on third of the entire fund volume belonged to Articles 6, 8 and 9 funds under the EU Regulation on sustainability-related disclosures in the financial services sector (SFDR).

A closer look at the different investment approaches shows that the highest growth rates were achieved with regard to sustainable thematic investments and impact investing, mainly in four asset classes, namely equity, corporate bonds, sovereign bonds and real estate.

ii Sustainable finance instruments

Bonds

With regard to the types of sustainable finance instruments, the Swiss market is still largely driven by equity investments and the corporate bonds market, where sustainability-linked bonds, sustainable bonds, a vast variety of green bonds and even social bonds have been issued and listed on the Swiss Stock Exchange (SIX). Examples for these bond classes are the first green bond listed on SIX and issued by the European Investment Bank (2014), the first listed sustainability bond by Raiffeisen Schweiz (2019), the first listed sustainability-linked bond by Novartis (2020) and in the autumn of 2021 the first listed social bond issued by Central American Bank for Economic Integration (CABEI).[14] The Federal Council also decided on a framework for issuing green sovereign bonds that is based on the Green Bond Principles (GBP) of the International Capital Market Association, which are viewed as the international market standard.[15] In October 2022, the Swiss Confederation has issued its inaugural 766 million Swiss franc green Confederation bond to fund projects that have a positive impact on the environment, primarily in the areas of public transport, biodiversity, international cooperation and research.[16]

Credit financings

In contrast, ESG-linked credit financing transactions are in most cases limited to corporate credit financing transactions. However, in a recent survey, 13 of the 24 Swiss cantonal banks indicated that sustainability will become a very high priority in the lending business within the next 10 years. The classic credit rating was expanded to include an ESG rating as part of the credit assessment and credit pricing.[17] The ESG rating can be used to adjust the conditions for granting loans to the development of the sustainability of the company or to impose specific conditions in the loan agreement.[18] Thus, ESG-linked credit financing transactions do usually not provide for a 'use of proceeds' concept where funds raised shall exclusively finance specific green, sustainable or social business transactions or assets, but instead the parties agree that the funds shall be applied towards the transformation of the business activities into more sustainable activities in general by agreeing on some key performance indicators (KPIs). These KPIs vary from industry to industry and leave the borrower with more flexibility as to which corporate purposes the funds shall be used in contrast to 'use of proceeds' clauses. Furthermore, there is typically no hard requirement to meet certain KPIs, but rather an adjustment in form of a decrease or increase of the margin depending on whether the borrower meets (or even exceeds) or fails to meet the KPIs. Although ESG-linked credit financings are rapidly growing in numbers in Switzerland, one of the challenges is the monitoring, reporting and auditing of compliance with the ESG criteria defined in the respective documents.

The publication by the Loan Market Association (LMA) of their Sustainability-Linked Loan Principles, Green Loan Principles and Social Loan Principles (each in February 2023) and their Draft Provisions for Sustainability-Linked Loans (in May 2023) might further boost an increase in ESG-linked loans in Switzerland since the LMA standards are widely recognised. They aim at: (1) helping the involved parties to select the right KPIs for a successful ESG-linked credit financing transaction; and (2) promoting the development of green loan and social loan products by providing a recommended framework of market standards and guidelines for use across the green loan market and social loan market.[19]

Secondary market

To financial service providers who manage portfolios or give investment advice with regard to financial instruments to clients in Switzerland, the provisions of the Federal Act on Financial Services (FinSA)[20] apply. Thus, the trading for clients of sustainable bonds may be subject to regulatory provisions under the FinSA, mainly the code of conduct obligations, which must be observed when dealing with retail clients or professional clients (dealings with institutional clients are exempt). One of these obligations particularly relevant with regard to sustainable bonds is the duty to provide the client with information on the financial instruments offered by the service provider.[21] An obstacle in providing the client with all the necessary information on green products can be seen in the absence of a binding definition in Switzerland of what constitutes green, social or sustainable bonds (in contrast to the EU taxonomy system, see below).

Sustainable disclosure requirements and taxonomy

i Sustainable disclosure reporting requirements in Switzerland

General reporting requirements on non-financial matters

In November 2020, the popular initiative 'The responsible business initiative – protecting human rights and the environment' (Responsible Business Initiative) was narrowly rejected, but the indirect counterproposal of the Swiss parliament (Counterproposal) came into force at the legislative level. The Counterproposal introduced general reporting and disclosure obligations for certain categories of companies on non-financial matters (e.g., risks of their business activities regarding environmental matters, social issues, employment-related issues, human rights and the combating against corruption),[22] The new regulations are to be found in the CO under the newly added section 'transparency on non-financial matters' (CSR reporting).[23]

The provisions apply to companies (1) of public interest (i.e., companies listed on the stock exchange or companies supervised by FINMA),[24] (2) with at least 500 full-time equivalent positions on annual average in two consecutive financial years, taking into account Swiss and foreign subsidiaries, which (3) exceed at least one of the following amounts in two consecutive financial years: a balance sheet total of 20 million francs or sales revenue of 40 million francs, taking into account Swiss and foreign subsidiaries.-[25] If those requirements are met, financial intermediaries must also comply with the reporting obligations under Article 964a et seq. CO.[26] Exemptions apply to companies that are subsidiaries of companies to which the aforementioned requirements apply or to subsidiaries of companies that are under the obligation to prepare an equivalent report under foreign law.[27] For example, the ESG reporting obligations may be applicable to a non-listed Swiss subsidiary of a foreign company if the subsidiary has bonds outstanding, unless the direct or indirect parent company is subject to equivalent reporting obligations under foreign law, such as the EU Non-Financial Reporting Directive (Directive 2014/95).

The report on non-financial matters must be produced for the first time for the business year 2023 and requires the approval of the supreme management or governing body of a company, but must not be submitted for external review or audit. It must be published and remain publicly accessible for at least 10 years.[28] If a company does not pursue a concept in one of the areas of non-financial matters mentioned above, the 'comply or explain' approach applies, as is also the case under EU law and is intended to enable investors and consumers in particular to assess the credibility of the company's justification.[29]

As mentioned above, the reporting obligations under the CO cover the areas of environmental matters, social issues, employment-related issues, human rights and combating corruption. With respect to reporting on climate matters, Switzerland officially declared its support to the TCFD on 12 January 2021 and will implement the recommendations of the TCFD by means of an implementing ordinance issued by the Federal Council. On 23 November 2022, the Federal Council adopted the relevant implementing ordinance, which will come into force as of 1 January 2024.[30] This Ordinance sets out requirements for climate reporting based on the recommendations of the TCFD and establishes a presumption that companies that make climate related disclosures based on such recommendations comply with their respective reporting obligation under the CO. Companies can also opt for a different disclosure concept but must then establish that the concept complies with Article 964b(1) CO as regards climate matters.

Specific reporting requirements on child labour and conflict minerals of companies

The second significant change of law the Counterproposal introduced concerns only companies with touchpoints with sensitive areas such as child labour and conflict minerals.[31] These companies must comply with special due diligence and reporting obligations, also introduced in the CO under the newly added section 'due diligence and transparency in relation to minerals and metals from conflict-affected areas and child labour' and regulated in further detail by the Federal Council in the corresponding ordinance (the Ordinance). The Ordinance is aligned with Regulation (EU) 2017/821 on conflict minerals by foreseeing the same thresholds on annual import quantities of minerals and metals up to which a company may qualify for an exemption from the due diligence and reporting obligations. The Federal Council may adjust the thresholds in accordance with future adjustments of the EU regulation.[32]

In principle, small and medium-sized enterprises are exempt from the due diligence and reporting obligations, whereby the Federal Council has adopted a catch-all provision in the Ordinance for evidenced cases with regard to child labour. According to this, small and medium-sized enterprises are also subject to the due diligence and reporting obligations if they offer products or services that have obviously been produced with the use of child labour. This is an extension of the obligations compared to the rules in the EU, which only have specific due diligence obligations regarding conflict minerals.[33]

Specific disclosure requirements of banks and insurance companies

To achieve more transparency with regard to climate-related risks at supervised institutions, FINMA clarified the disclosure requirements for significant financial institutions (e.g., such as large banks and insurance companies) in July 2021 by amending its FINMA Circulars 2016/1 and 2016/2 regarding the public disclosure of banks and insurers. The specific disclosure requirements entered into force on 1 January 2022 and are largely based on the recommendations of the TCFD. The disclosure requirements require the banks and insurance companies to describe their material climate-related financial risks and their impact on their business strategy, business model and financial planning. Furthermore, the financial institutions are required to disclose their process for identifying, measuring and addressing these risk as well as describe their governance structure in place.[34]

Investment product disclosure

On 3 November 2021, FINMA published FINMA Guidance 05/2021 on preventing and combating greenwashing. In FINMA Guidance 05/2021, FINMA sets out rules on: (1) sustainability-related information for Swiss collective investment schemes (funds); (2) the organisational structure of institutions that manage sustainability-related funds; and (3) rules of conduct at the point of sale for sustainability-related products.[35] For other financial instruments such as structured products, there is still no regulation in Switzerland (not even in the area of self-regulation), unlike, for example, the Disclosure Regulation in the EU.

Self-regulation of SIX and SIX-flagging

Since 2017, an issuer may report to SIX Exchange Regulation (the independent and autonomous entity within the SIX group monitoring compliance with the applicable regulations) that it is producing a sustainability report in accordance with an internationally recognised standard (opting in). SIX will publish such opting in on its website for the purpose of informing market participants. The issuer must publish this sustainability report on its website within eight months of the balance sheet date for the annual financial statements and the report must remain available for five years from the date of publication.-[36] So far, almost 40 issuers have decided to report their producing of a sustainability report to SIX Exchange Regulation.[37]

Furthermore, SIX has introduced a special flagging system for green bonds, social bonds and sustainability or sustainability-linked bonds. The system was designed to strengthen sustainable investing and to give such bonds a higher visibility for investors. To be eligible and flagged, the bonds must meet relevant criteria of the relevant International Capital

Market Association principles and guidelines.[38] Among these principles are reporting duties of the issuer of such bonds. The annual report must contain information on the use of proceeds and include a list of the projects that shall be supported by the proceeds.[39]

ESG guidelines from the Swiss Bankers Association

In June 2020, the Swiss Bankers Association issued minimum standards for financial service providers, clarifying the consideration of the ESG criteria in the context of the FinSA conduct rules. The guidelines are not legally binding but designed to assist the financial service providers in advising their clients on the influence or impact their investments can have from an ESG perspective and to foster the application of ESG criteria in the market.-[40]

ii Taxonomy

In Switzerland, there is currently no taxonomy system in place comparable to that in the EU. However, the Swiss banking industry is in the process of comparing various international taxonomy approaches with each other to determine whether the existing legislation in Switzerland needs to be amended or new regulations need to be adopted. For this purpose, the Swiss Banking Association has set up an interdisciplinary working group to compare the various international taxonomy approaches to identify whether there is a need for action on the part of the Swiss legislative authorities.[41] However, it is generally to be expected that the EU taxonomy standards will also become established as the market standard in Switzerland. Particularly because Switzerland is involved in international initiatives such as the Network for Greening the Financial System (NGFS) and the International Platform for Sustainable Finance (IPSF), and therefore a separate regulation only with regard to Switzerland would not be expedient.[42] The Federal Council is also of the opinion that a separate Swiss taxonomy makes little sense for economic reasons in particular, as well as with regard to comparability with other taxonomy systems. However, the Federal Council welcomes cooperation between the authorities and market participants at an international level and is closely following developments in the international environment and in the EU in particular.[43]

ESG data, ratings and reporting

i Scope of ESG reporting

The Responsible Business Initiative would have gone much further than the now adopted Counterproposal by opening up Swiss companies to litigation in Swiss courts for alleged violations of international human rights or environmental laws abroad. The Counterproposal places far fewer obligations on companies, but nevertheless raises various questions for companies in the concrete implementation of their reporting and due diligence obligations.

As mentioned above under Section V.i titled 'Sustainable disclosure reporting requirements in Switzerland', the general due diligence and reporting obligations regarding non-financial matters are directed at those companies that meet the requirements as outlined above

(Article 964a CO). The specific obligations, on the other hand, are only directed at: (1) companies that either import certain minerals or metals from conflict or high-risk areas into Switzerland or process them here; and (2) companies for which there is reasonable suspicion that their products or services are manufactured or provided using child labour (Article 964j et seq.).

The specific reporting and due diligence obligations apply to the company's entire supply chain (up to Scope 3 level emissions). The companies need to maintain a management system and stipulate therein: (1) their supply chain policy for minerals and metals that potentially originate from conflict-affected and high-risk areas; (2) their supply chain policy for products or services in relation to which there is a reasonable suspicion of child labour; and (3) a system by which the supply chain can be traced. The companies furthermore have to identify and assess the risk of harmful impacts in their supply chain and draw up a risk management plan as well as take measures to minimise the identified risks.[44]

Although the obligations are very far-reaching, they are only based on a best-effort approach. In contrast to the Responsible Business Initiative, the Counterproposal does not provide for civil liability. In the event of non-compliance, however, companies are threatened not only with reputational damage, but also with criminal consequences.[45]

ii Challenges in reporting

The main challenges companies face when it comes to collecting ESG data are that only a limited amount of the required data can be found in the companies' own records, whereas a large amount must be gathered from third parties such as direct and indirect suppliers of the company. To collect the necessary data, the companies need to know their businesses' exact supply chains, which can be rather difficult since those can spread over many countries and involve a vast number of participants.[46]

Sustainable finance incentives

i Incentive schemes

Based on the current CO2 Act, the government has created a technology fund offering loan guarantees to banks or other suitable lenders providing financing to Swiss companies whose novel products contribute to a sustainable reduction in greenhouse gas emissions. The technology fund is financed with up to 25 million Swiss francs in revenue from the CO2 levy on fossil fuels per year.[47] Given the scope and cap, the technology fund is primarily a financing instrument for start-up companies.

Furthermore, a third of the revenue from the CO2 levy, but no more than 450 million francs per year, is used to finance measures to reduce long-term CO2 emissions from buildings.[48] The bulk of these revenues is passed on to the Swiss Cantons under the Federal Energy Act for allocation to programmes and measures for the economical and efficient use of energy, the use of renewable energy and the use of exhaust heat in the buildings sector. According to a report commissioned by the Federal Department of Energy, a total of 2.3 billion francs in subsidies has been paid out under the respective programmes between 2010 and 2020 triggering a total of 4.56 billion francs in sustainability-related investments and resulting in a reduction of energy consumption by Swiss buildings by 2.5 billion kWh and of CO2 emissions by 660,000 tonnes so far which will accumulate to a reduction of 65.5 billion kWh and 16 million tonnes of CO2, respectively over the entire lifespan.

The Draft CO2 envisages additional financial assistance schemes, inter alia, for the installation of charging infrastructure for electric vehicles, the cross-border passenger rail transport and the promotion of CO2-neutral propulsion technologies.

ii Transition frameworks

Switzerland does not currently have a comprehensive transition framework for the economy. In the energy sector, the energy strategy 2050 provides for a framework for the transition of the Swiss energy system towards renewable energy, including an exit from nuclear energy production, and the first package of implementing measures was approved in a referendum in 2017. However, the expansion of renewable energy production capacities has been slower than anticipated, and the energy strategy 2050 has drawn criticism for its lack of viability and over-reliance on energy imports in the wake of the ongoing energy crisis.

A growing number of private companies is committing to reduction targets and net zero goals on a voluntary basis. If the Draft CO2 Act is implemented, all companies will be able to be exempted from the CO2 levy on fossil fuels if, in return, they make a commitment to reduce their fuel emissions from oil and gas and demonstrate how they can reduce them to zero in the longer term. Under the current CO2 Act, the exemption option is limited to certain specific emissions-intensive industry sectors.

Climate change, nature and biodiversity impacts

i Enforcement action

FINMA has carried out investigations into the distribution of financial products and services of various providers and carried out several on-site inspections of supervised financial institutions. While it does not comment on specific actions taken, FINMA issued its Greenwashing Guidance in May 2021 (see above).

ii Impact on meeting climate targets

Switzerland missed its 2020 emissions reduction target of 20 per cent below 1990 levels, achieving a reduction of only 19 per cent despite emissions falling sharply in 2020 compared to the previous year as a consequence of the covid-19 pandemic and a warm winter.[49]

Greenwashing and climate litigation risks

Climate-related litigation is still scarce in Switzerland, with the bulk of cases concerning climate activists challenging criminal charges for protest activity (e.g., for trespassing, damage to property and duress). The frequently used argument that protesters should be acquitted on the grounds that they had been acting to avert a state of (climate) emergency, was ultimately dismissed by the Swiss Federal Supreme Court in two instances. A group of senior women took a different approach to climate activism and, in 2016, filed a complaint against the Swiss government in 2016 alleging that it had violated Articles 10 (right to life), 73 (sustainability) and 74 (environmental protection) of the Swiss Constitution as well as Articles 2 and 8 of the European Convention on Human Rights (ECHR) and demanding more ambitious emissions reductions targets as well as more stringent measures to reach such targets. The case is currently pending before the European Court of Human Rights.

In July 2022, four inhabitants of the Indonesian island of Pari backed by three NGOs instigated civil proceedings against Holcim, a major building materials group headquartered in Switzerland, requesting the reduction of the group's carbon emissions as well as financial compensation for climate change-related damage on Pari and financial contributions to adaption measures. The case, which is the first publicly known case of a company being directly sued in Switzerland for its carbon emissions, is currently pending before the Zug Cantonal Court.

In addition, there has been a sharp increase in greenwashing complaints lodged by climate protection and consumer organisations with the Swiss State Secretariat for Economic Affairs (SECO) and the Swiss Fair Advertising Commission (SFAC) in connection with climate or CO2-related advertising claims by companies and international sports associations, alleging infringement of the either or both of the Federal Act against Unfair Competition or the International Chamber of Commerce's Code on Advertising and Commercial Communication Practices. While the two authorities do not have the power to themselves administer civil or criminal sanctions, both SECO and SFAC have decided in favour of the complainants and have requested or recommended that the respective claims be adjusted or removed. As a consequence, there is an increased risk of (follow-on) litigation in this field too.

Outlook and conclusions

To achieve its 50 per cent reduction target by 2030 and its 2050 net zero goal, Switzerland will need to implement the long-term climate strategy adopted by the Swiss Federal Council in January 2021. The strategy builds on the measures of the Draft CO2 Act which, according to the Federal Council is 'essential' for achieving Switzerland's climate target,[50] but is yet to pass the legislative process and is unlikely to enter into force before 2025.

However, while providing for climate risk monitoring obligations of FINMA and SNB, financial market participants are not the primary addressees of the Draft CO2 Act. It will therefore be interesting to see what the legislative proposal by FDF to prevent greenwashing will bring. In parallel, we expect that market participants will pick-up on the implicit criticism by the FDF by further strengthening self-regulatory schemes for sustainable finance. Given the Swiss economy's high degree of international integration, market practice will further evolve in line with the laws of neighbouring economies, in particular the EU and international soft law, in particular in the areas of CSR reporting and disclosures as well as sustainable finance instruments.

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Introduction

The regulation of sustainable finance in the United Arab Emirates (UAE) spans several jurisdictions, considering that the UAE operates a federal system with seven emirates, as well as numerous free zones, in many cases with their own laws and regulations. Some aspects of the regulatory framework are voluntary while others (including those relating to the disclosure regime) are mandatory.

The UAE has sought to cement its position as a leading economy and a destination of choice for companies with its ambition to become a global hub for sustainable finance, by identifying the area as a solution to combat climate change, expedite the necessary green energy transition and achieve the United Nations Sustainable Development Goals (SDGs). The UAE was the first country in the Middle East to sign the Paris Agreement, which was negotiated at the 21st United Nations Climate Change Conference of Parties (COP) in 2015 by 196 parties, and which came into force in November 2016. In 2021, the UAE also became the first country in the Middle East and North Africa (MENA) region to set a net zero carbon emissions commitment by 2050.

In line with this vision, the UAE hosted COP28, becoming the first Gulf Cooperation Council (GCC) country to do so. Central themes of COP28 included, among other things, exploring avenues to accelerate energy transition, transforming climate finance to bridge the gap in funding needed and establishing a new financial framework to combat climate change.

Year in review

The past year has seen the following notable events:

1. 2023 was declared the 'Year of Sustainability' with the slogan 'Today for Tomorrow' by His Highness Sheikh Mohamed bin Zayed Al Nahyan, the President of the UAE;-[2]
2. the 15th edition of Abu Dhabi Sustainability Week was held from 14 January to 19 January 2023, culminating in the 5th edition of the Abu Dhabi Sustainable Finance Forum, which was held on 19 January 2023;
3. the Abu Dhabi Global Market (ADGM) launched a consultation paper on its sustainable finance regulatory framework (the ADGM Sustainable Finance Regulatory Framework) in November 2022, which concluded in January 2023. The ADGM Sustainable Finance Regulatory Framework came into force on 4 July 2023;
4. on 7 February 2023, the Virtual Assets Regulatory Authority (VARA) issued its rulebook for the regulation of virtual assets in Dubai;
5. on 6 March 2023, the federal and local governments of the UAE signed the Net Zero 2050 Charter;

6. the ADGM and the United Arab Emirates' Sustainable Finance Working Group (SFWG) launched a consultation paper in March 2023 regarding the 'Principles for the effective management of climate-related financial risks', which concluded in May 2023 (the Climate Risk Principles). The Climate Risk Principles were launched on 13 November 2023, but still have to be issued by the relevant financial sector regulators to be implemented;
7. on 12 May 2023, the UAE Securities and Commodities Authority (SCA) issued its regulatory framework for Green and Sustainability-linked Bonds and Sukuk (GSLBS);
8. the Sustainable Finance Summit was held on 7 June 2023 at the Dubai International Financial Centre (DIFC);
9. on 26 September 2023, the UAE SFWG launched a consultation on the proposed 'Principles for Sustainability-Related Disclosures for Reporting Entities' to provide minimum standards for disclosures concerning sustainability-related matters and to allow investors and other stakeholders to make more informed decisions and better evaluate investment risks and opportunities;
10. the DIFC Sustainable Finance Framework was announced on 4 October 2023;
11. the Future Sustainability Forum was held on 4 October and 5 October 2023 at the DIFC;
12. the 8th edition of the World Investment Forum with the theme 'Investing in Sustainable Development' was held from 16 October to 20 October 2023 in Abu Dhabi, coinciding with the 2nd Global Dialogue in preparation for COP28 on 'Climate Finance and Investment', which was held from 15 October to 17 October 2023 at the ADGM. A pre-forum event was held on 15 October 2023 to discuss the International Financial Reporting Standards Foundation's newly issued Sustainability Disclosure Standards;
13. the UAE hosted COP 28 from 30 November to 12 December 2023; and
14. the Abu Dhabi Sustainability Week held a special edition at COP28 on 4 December 2023.

Regulation and policy

As noted above, the governing framework at the federal level differs from what applies in financial free zones, namely the ADGM and the DIFC. As a result, regulators charged with implementing sustainable finance regulations are also multi-layered. For instance, regulators at the federal level include the Central Bank, the SCA, the UAE SFWG and the Ministry of Climate Change and Environment (MOCCE).

In the DIFC, the following authorities exercise some form of oversight over sustainable finance: the Dubai Financial Services Authority (DFSA), the Dubai Islamic Economy Development Centre, and the Dubai Sustainable Finance Working Group (DSFWG). In Dubai and outside of the DIFC, the Dubai Land Department and Real Estate Regulatory Authority and VARA also regulate sustainable finance.

The key ADGM regulators are the Financial Services Regulatory Authority (FSRA), and the ADGM Registration Authority.

We have set out below an overview of the applicable sustainable finance framework in each of these jurisdictions.

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The key ADGM regulators are the Financial Services Regulatory Authority (FSRA), and the ADGM Registration Authority.

We have set out below an overview of the applicable sustainable finance framework in each of these jurisdictions.

i UAE mainland

The sustainable finance framework operating at the federal level is codified in various regulatory instruments such as the UAE's Green Agenda 2030, UAE Net Zero 2050 Strategic Initiative, UAE Vision 2021, UAE Sustainable Finance Framework 2021 to 2031 and the 2020 UAE Guiding principles on Sustainable Finance.

Stock exchanges continue to play a critical role in driving sustainability regulations in the UAE. The various environmental, social and governance (ESG) disclosure guidance documents adopted by UAE stock exchanges, and the sustainability index created by the Dubai Financial Market (DFM) in particular, remain instrumental in monitoring impact investing and sustainability more generally in the country.

In 2019, the SCA published its Master Plan for Sustainable Capital Markets, with the aim of providing channels for funding sustainable projects, among other objectives.[3] Rules governing sustainable finance can also be derived from the following instruments: the SCA Corporate Governance Code for Public Joint Stock Companies (the Governance Code), SCA Decision No. 21/RM/2023 on the Regulation of Green and Sustainability-Linked Bonds and Sukuk (the SCA Green Bonds Decision) and SCA Decision No. 29/RM/2023 on the Exemption from the Fees of Registration of Green and Sustainability-Linked Bonds and Sukuk in 2023.

In 2021, the UAE SFWG published its Public Statement on Collaboration on Sustainable Finance in the UAE. The statement identifies three topics most relevant to the nature of financial services in the UAE and internationally recognised as conducive of change: (1) strengthening sustainability disclosure; (2) fostering sustainability-focused corporate governance; and (3) designing the UAE's Sustainable Finance Taxonomy.

Dubai mainland instruments include: Law No. 4 of 2022 Regulating Virtual Assets in the Emirate of Dubai, the 2023 Rulebooks for the regulation of virtual assets in Dubai (excluding the DIFC) and the 2016 Dubai Sustainable Finance Declaration.

ii ADGM

In 2019, the ADGM issued its ADGM Sustainable Finance Agenda establishing a roadmap for sustainable finance in the ADGM based on four pillars: (1) regulation; (2) collaboration; (3) awareness; and (4) ecosystem. As part of the regulation pillar, the ADGM adopted the ADGM Sustainable Finance Regulatory Framework, which is codified in the Companies Regulations 2020 (as amended) and the FSRA rules (such as the conduct of business rulebook, the fund rules and the market rules). As part of the collaboration pillar, the ADGM initiated the Abu Dhabi Sustainable Finance Declaration in 2019 seeking to establish a partnership between private and public institutions in the region to advance sustainable finance. As part of the awareness pillar, an annual Abu Dhabi Sustainable Finance Forum is hosted. As part of the ecosystem pillar, the ADGM Sustainable Finance Platform tracks data and trends in key sustainable finance areas.

iii DIFC

DIFC sustainable finance initiatives include the DIFC Sustainable Finance Framework, DFSA Business Plan 2023–2024 and DFSA Task Force on Sustainable Finance.

In 2023, the DSFWG published a white paper on unlocking the potential of ESG innovation in the UAE and across the globe, with the aim of (among other things) providing actionable recommendations that will serve as a roadmap for fostering an impact-driven ESG innovation ecosystem and push the country to becoming a global hub. The DSFWG has also published several guidance documents such as the Net Zero Guide for UAE companies, the Sustainability-Linked Loans Guide, the Sustainable Investing Guide and the Sustainable Issuance Guide.

Sustainable finance instruments

i SCA

The SCA Green Bonds Decision defines Green Bonds and Sukuk (GBS) as bonds or *sukuk* whose subscription proceeds are entirely used to finance a new project or refinance an existing project, totally or partially, in line with prescribed core components. Sustainability-Linked Bonds and Sukuk (SLBS) are defined as bonds or *sukuk* with structural or financial properties, or both, concerning the future key performance indicators (KPIs) of the issuer as well as the sustainability objectives agreed upon in the offering documents.

Core components of GBS and SLBS are aligned on the International Capital Market Association (ICMA) Green Bond Principles and the ICMA principles on sustainability-related *sukuk* or bonds (the ICMA SLBS Principles), respectively. For GBS, they include provisions on the: (1) allocation of subscription proceeds; (2) assessment and selection of projects; (3) management of subscription proceeds; and (4) preparation of reports. For SLBS, they include: (1) selection of KPIs; (2) assessment of the chosen KPIs' suitability; (3) determination of the SLBS specifications; (4) preparation of reports and disclosure; and (5) verification.

Upon fulfilment of the requirements of the SCA Green Bonds Decision, an issuer may submit an application to the SCA for issued bonds or *sukuk* to be designated as GSLBS. The GSLBS will lose this designation if they no longer meet the requirements on an ongoing basis.

ii ADGM

The ADGM Sustainable Finance Regulatory Framework establishes a voluntary opt-in regime with minimum eligibility requirements for green-labelled financial instruments.[4] The framework aims to enable capital to be invested towards financing sustainable projects and the net zero transition.

A fund established or domiciled in the ADGM (i.e., a 'domestic fund'), as long as the fund meets the investment and attestation requirements for the relevant designation, may choose to obtain an:

1. ADGM green fund designation, for funds comprised predominantly of assets that are considered green according to an existing green taxonomy (e.g., the ASEAN or EU taxonomy, or the forthcoming UAE taxonomy) or that are included or tracked in one or more EU Paris Aligned Benchmarks (PAB);[5] or
2. ADGM climate transition fund designation, for funds comprised predominantly of assets that are not green, but have the potential to be over time, and that are: (1) aligned with a climate transition taxonomy;[6] (2) considered GSLBS;[7] (3) tracking, or are included in, one or more EU Climate Transition Benchmarks; (4) greening real estate assets and infrastructure;[8] or (5) companies with a public, 'credible' net zero strategy.[9]

The attestation requirement for both funds is substantially similar. The fund manager must appoint an independent third party to attest, at least annually, that the fund complies with its investment requirement, as explained below. The fund manager of a fund reserved for qualified investors (QIFs) may self-attest that the investment requirement for such fund has been met.

Public funds (i.e., funds open to retail investors) must obtain approval from the ADGM authorities to use the ADGM Green Fund Designation or the ADGM Climate Transition Fund Designation, whereas other funds, open only to sophisticated investors such as QIFs, only need to notify the authorities.

Other designations include discretionary managed ADGM Green Portfolios and ADGM Climate Transition Portfolios offered to retail investors that are essentially identical to those discussed above for ADGM Green Funds or ADGM Climate Transition Funds, and green and sustainability-linked bonds and *sukuk*.

An issuer of financial instruments may apply to obtain an ADGM Green Bond Designation, an ADGM Sustainability-Linked Bond Designation, an ADGM Green Sukuk Designation or ADGM Sustainability-Linked Sukuk Designation if the bonds or *sukuk*: (1) are offered in the ADGM (regardless of the issuer's place of establishment); (2) conform to the ICMA Green Bond Principles, the ICMA SLBS Principles or an equivalent framework; and (3) are assessed pre-issuance and annually by a third party, with a copy of the review sent to the ADGM authorities.

Sustainable disclosure requirements and taxonomy

i SCA

The SCA Green Bonds Decision requires GBS issuers to provide a prospectus that includes a list of prescribed information regarding a project's sustainability, selection and financing. The issuer must also deliver a semi-annual report to the SCA with information on the use of subscription proceeds, a description of the projects funded and their environmental impact. This report must be updated on a regular basis, including in the event of a material change, must be disclosed to investors and must abide by the standards set by the Global Reporting Initiative (GRI) or the International Sustainability Standards Board (ISSB).

Furthermore, the SCA Governance Code provides that public joint stock companies listed on a UAE stock exchange (such as the Abu Dhabi Securities Exchange (ADX), the DFM or NASDAQ Dubai (such entities being 'listed PJSCs')) must publish an annual sustainability report. Currently, this mandatory disclosure applies only to listed PJSCs, while private and state-owned companies are only encouraged to issue this sustainability report. Listed PJSCs also have the option of choosing from the various sustainability disclosure guidance documents available, including those issued by the respective stock exchanges where they are listed.

ii VARA

The VARA issued its rulebooks for the regulation of virtual assets in Dubai (excluding the DIFC), in February 2023. Three levels of ESG disclosure are set out: voluntary, compliance and mandatory. The VARA determines the level of ESG disclosure required for each virtual asset service provider (VASP) during their licensing process. In making such a determination, the VARA may consider the following non-exhaustive factors: (1) number of employees; (2) turnover and other financial information; and (3) business model and virtual asset activities. VASPs may choose at any time to comply with a higher ESG disclosure level than that set by the VARA. However, VASPs should maintain the same ESG disclosure standard across their group, to the extent possible.

A VASP involved in virtual asset mining or staking activities, irrespective of its designated ESG disclosure level, must disclose publicly on its website, information concerning its: (1) use of renewable or waste energy in the conduct of such activities; and (2) decarbonisation and emission reduction initiatives.

Furthermore, VASPs should carefully consider their social and environmental responsibilities when selecting service providers.

All ESG disclosures and reports will be kept confidential by VARA, unless otherwise provided or disclosed on an anonymous basis.

iii ADGM

The ADGM Sustainable Finance Regulatory Framework establishes a 'comply or explain' ESG disclosure regime for large ADGM-headquartered companies that are either: (1) companies with a turnover of US$68 million or greater; or (2) fund and asset managers with US$6 billion in assets under management or greater. Entities choosing to disclose on ESG must include information on their position, development, strategy and performance in accordance with a freely chosen international framework (e.g., the rules issued by the ISSB, the Task Force on Climate Related Financial Disclosures (TCFD), the GRI or other rules – presumably including also other jurisdictions' national regulatory regimes). These entities must also include the necessary ESG disclosures in their annual accounts or a separate document submitted to the ADGM registrar.[10]

Companies and fund or asset managers meeting the above thresholds can choose not to provide the required information, but they must submit a clear and reasoned explanation for their decision to the ADGM registrar. Entities that do not meet the conditions may voluntarily choose to comply.

Furthermore, the ADGM rules also prescribe specific disclosures that mining and petroleum companies have to follow in their prospectus when they make an offer of securities. They must include the policies and practices implemented to operate in a sustainable manner with regard to: (1) environmental and social issues; (2) the impact of their business practices on the environment and local communities; and (3) the social and environmental risks that they face. This information must be updated annually.

iv GCC

On 9 January 2023, the Exchanges Committee of the GCC published a set of 29 unified indicators for voluntary ESG disclosures by local listed entities.[11] The indicators do not replace existing ESG disclosure guidelines issued by the GCC's individual stock exchanges or regulators, but indicate an intention towards further harmonisation between GCC countries' sustainability-related regulations. They, at the very least, facilitate uniformity in ESG disclosures by listed companies across the region.[12]

v Taxonomy

The UAE Sustainable Finance Framework endeavours to establish a nationwide common taxonomy for sustainable finance. Conversely, as discussed above in Section IV, the ADGM Sustainable Finance Regulatory Framework does not mandate the use of a specific taxonomy and instead provides a list of acceptable taxonomies depending on the financial instrument. This list includes the UAE taxonomy (once it is published), but a company can comply with the ADGM rules by following any other recognised taxonomy from a country, regulator or standards-setting body outside of the UAE. It is unclear, at this time, whether the DIFC Sustainable Finance Framework will create a new taxonomy or allow the use of one more acceptable taxonomies, similar to the ADGM Sustainable Finance Regulatory Framework.

ESG data, ratings and reporting

As discussed in the previous Section, not all companies are required to report on ESG. Listed PJSCs may comply with this reporting requirement based on any of the sustainability standards discussed above. The ADX and DFM disclosure guidelines contain 31 and 32 ESG indicators, respectively, mapped against the GRI and SDGs, including GRI 305 on greenhouse gas emissions.

Nevertheless, all companies, even listed PJSCs, are encouraged by regulators to go even further than current requirements, as explained in the previous Section. However, the biggest challenge remains the multiplicity of disclosure regimes, such as the GRI, the ISSB, the TCFD and the GCC reporting guidelines, that are available if companies wish to report more than the bare minimum.

The UAE does not currently have any green or sustainable benchmarks. It mandates the use of accepted PABs or climate transition benchmarks. Financial entities are also not required to produce a transition plan in the UAE.

The ADGM Sustainable Finance Platform tracks and benchmarks sustainable finance data across the region via five themes: (1) responsible banking; (2) responsible investing; (3) sustainable products ; (4) ESG disclosure; and (5) sustainable capital markets. Each theme follows KPIs that are aligned with the ADGM Sustainable Finance Guiding Principles.[13] There are currently no regulatory requirements specific to ESG rating providers in the UAE.

Sustainable finance incentives

The UAE offers no direct sustainability incentives in the form of tax credits, subsidies or other business incentives. The UAE has also not imposed any oil surplus revenues tax, and this seems unlikely to change in the foreseeable future. Oil and gas production is a critical component of the UAE's government revenue, as 30 per cent of the country's GDP is directly based on its oil and gas output. Each of the emirates has its own system of oil and gas taxation, which are broadly similar:

1. oil and gas companies are taxed under concession agreements or fiscal letters that typically supersede Emirati tax decrees, are agreed on a case-by-case basis and are not publicly available; and
2. typically, these oil and gas taxation systems feature a combination of a royalty of 12.5 to 20 per cent (escalating as production increases) and income tax typically set at 55 per cent (sometimes also escalating with production), in each case applied to the revenue deemed generated by production, using an agreed reference price rather than market price.

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i Support for the private sector

While the UAE offers no direct sustainability incentives, the following is a good example of how the UAE indirectly supports the private sector's endeavours to operate more sustainably, namely by way of subsidising manufacturers' gas and electricity bills for, among other things, efficient energy management in Abu Dhabi.

In 2022, the Abu Dhabi Department of Economic Development (ADDED) launched the Land Incentives Program, part of an effort to nurture local industry. Under this programme, long-term leases are offered at below-market rates (as low as 5 dirhams per square metre) in an effort to promote manufacturing growth.

ADDED has also launched the Energy Tariff Incentive Program (ETIP 2.0), in collaboration with the Abu Dhabi Distribution Company and Al Ain Distribution Company.

Under this initiative, manufacturers may receive preferential rates for gas and electricity, based on eligibility criteria, one component of which is efficient energy management (other criteria include enhancing productivity, improving the supply chain, using skilled labour and supporting emiratisation).

In October 2022, ADDED reported that 55 manufacturing entities had participated in its programme, benefiting from 24 billion dirhams of support, increasing their productivity by 15 per cent.

ii Transition frameworks

In 2017, the UAE launched the UAE Energy Strategy 2050, which targets the following energy mix:

1. clean energy: 44 per cent;
2. gas: 38 per cent;
3. clean coal: 12 per cent; and
4. nuclear: 6 per cent.

The strategy is 'a joint effort of all energy-related authorities and executive councils in the UAE and falls under the supervision of the federal government'.[14] The UAE government aims to invest 600 billion dirhams by 2050 to meet the growing energy demand and ensure sustainable growth for the country's economy.[15]

In July 2023, the strategy has been updated, given 'the recent dynamic changes in the energy sector, the maturity of emerging low-emission energy technologies, and the country's commitment to the objectives of the Paris Agreement'.[16] As part of this revision, several new goals were added, including the creation of 50,000 new green jobs by 2030, to triple renewable energy capacity to 14 GW by 2030, raise the percentage of clean energy in the total energy mix to 30 per cent by 2031 and become carbon-neutral by 2050.[17] Also, per the revised UAE Energy Strategy 2050, the UAE envisions producing 1.4 million tonnes of hydrogen annually by 2031 and estimates the figure to increase tenfold to 15 million by 2050. The UAE's clean energy firm Masdar is expected to produce 1 million tonnes of green hydrogen of the total 1.4 million tonnes by 2031 with the remaining 0.4 million tonnes of blue hydrogen produced using natural gas.[18]

By way of further example at the emirate level, in 2017, the Dubai government announced that as part of its five main pillars of the Dubai Clean Energy Strategy 2050 launched in 2015, it would establish a 100 billion dirham Dubai Green Fund to finance investments in the clean energy sector through partnerships with financial institutions.[19] Similarly, as part of the Abu Dhabi Industrial Strategy launched in November 2022, the government of Abu Dhabi will invest 10 billion dirhams to implement six transformational programmes by 2031 (including the Circular Economy Program).[20]

See also the above-discussed different policy initiatives in the UAE mainland, ADGM, and DIFC in Section III, as well as the stock exchange disclosure requirements discussed above.

Carbon markets and carbon trading

In 2022, the ADGM launched the world's first regulated carbon credit trading exchange, AirCarbon Exchange (ACX) and carbon clearing house, ACX Clearing Corporation.[21] Simultaneously, the FSRA became the first regulator to develop a framework that treats carbon as a commodity and regulates carbon credits and offsets as environmental instruments.[22]

As such, companies are able to trade and finance carbon credits like traditional financial assets while offsetting their carbon emissions on a regulated voluntary carbon exchange. These environmental instruments: (1) enable their holder to emit greenhouse gases into the atmosphere, in accordance with any emissions trading scheme; (2) attest to the reduction or removal of greenhouse gases into the atmosphere; or (3) attest to the environmental attributes of an underlying unit.

This endeavour will hopefully encourage companies to become carbon neutral and contribute to the UAE's net zero initiative. In 2022, the ADGM became the world's first international finance centre to achieve carbon neutrality by offsetting its carbon emissions.

However, the efficacy of carbon markets and offsetting as a strategy to reduce emissions is uncertain and has been criticised by some as a form of greenwashing.

Green technology

Below is an overview of some of the recent developments in the decarbonisation sphere in the UAE, which implies a diversified investment approach towards green technologies:

1. the Climate-Responsible Companies Pledge to reduce carbon emissions;
2. Abu Dhabi National Oil Company (ADNOC) allocating US$15 billion towards decarbonisation projects and initiatives to reduce its carbon emissions by 25 per cent by 2030;
3. ADNOC announcing a partnership to pilot technology that permanently mineralises CO2 within rock formations found in Fujairah using carbon capture and mineralisation technology to eliminate CO2 from the atmosphere;
4. the high-voltage direct current subsea transmission network project (Project Lightning) announced by ADNOC and Abu Dhabi National Energy Company PJSC. ADNOC has allocated US$3.8 billion towards Project Lightning;
5. joint development agreements between Masdar and the State Oil Company of the Republic of Azerbaijan, for onshore wind and solar projects, and integrated offshore wind and green hydrogen projects, with a total combined capacity of 4 gigawatts; and
6. the formation of an Expert Group between the UAE and the US to govern the Partnership for Accelerating Clean Energy (PACE). PACE aims to catalyse US$100 billion in financing, investment and other support and also deploy 100 gigawatts of clean energy by 2035.

Financing green projects in the UAE

The UAE does not offer subsidies to third parties for funding green projects. State-owned entities generally take the lead on energy projects, while private financing is also used. The below examples further demonstrate a dynamic and balanced investment focus at the various emerging green technologies:

1. nuclear: the Barakah Nuclear Power Plant was reportedly financed by US$19 billion of debt (including US$16.2 billion from the Department of Finance of Abu Dhabi, US$2.5 billion by KEXIM and US$250 million from local and international banks) and US$4.7 billion of equity (contributed by ENEC and KEPCO);[23]
2. solar: the 100MW Shams Concentrated Solar Power plant, the UAE's debut solar project, cost US$600 million and was financed by a consortium of international banks led by BNP Paribas, the National Bank of Abu Dhabi and Mizuho. Its equity is held by Masdar (60 per cent), Total (20 per cent) and Abengoa Solar (20 per cent);
3. carbon capture: in 2016, ADNOC built the region's first industrial-scale carbon capture utilisation and storage facility. It captures 800,000 tons of carbon dioxide with plans to expand six-fold by 2030; and
4.

Masdar: Abu Dhabi is dedicating US$20 billion to a renewable energy programme administered by Masdar, which has already resulted in the UAE's renewable energy portfolio expanding by 400 per cent over the past decade.

Climate change, nature and biodiversity impacts

It is difficult, at this stage, to assess how successful the different sustainable finance regimes in place in the UAE will be at reaching climate and nature-related targets as the frameworks are still in their infancy. However, there has been notable interest in sustainable finance products in the UAE, which saw a 32 per cent year-on-year growth in 2022, and in the broader region, which saw a 532 per cent year-on-year growth in 2021.[24] In July 2023, the UAE Ministry of Finance announced that it will submit data concerning government expenditure on climate and environmental initiatives to the International Monetary Fund and that such data will be available on the Climate Change Indicators Dashboard, which assesses the impact of national climate policies and spending on macroeconomic sustainability and transparency.[25]

The Climate Risk Principles encourage local financial firms to incorporate physical risk and transition risk into their risk management and governance structure. Physical risk refers to potential economic and financial losses arising from climate and weather-related events and the long-term progressive impact of climate change. Transition risk arises from the adjustment phase towards a lower-carbon economy, prompted by, notably, changes in climate policy, technological advancements or market trends.[26]

Greenwashing and climate litigation risks

There is currently no regulation directly addressing greenwashing in the UAE. However, the prohibition of greenwashing is captured in legislation proscribing false, misleading or exaggerated advertisements. The UAE also aims to curb greenwashing through the various ESG disclosure regimes that have been implemented. Furthermore, the ADGM endeavours to combat greenwashing with its prescribed attestation requirements and designation regime for funds, portfolios, bonds and *sukuk*. Similarly, the SCA aligned the regulation of GBS and SLBS with international best practices.

Furthermore, the UAE has been investing heavily in technology to achieve its net zero commitment and deliver truly sustainable products. This has been spurred, among other things, by consumer demand for products that are easily identifiable as sustainable.

There have not been any documented climate change, nature or biodiversity litigation cases in the UAE to date. However, climate litigation is a rising concern that is expected to become more prevalent in the coming years. So much so that the Climate Risk Principles identify liability risk, arising from climate-related compensatory claims and direct legal actions (such as emissions lawsuits), as one of the financial risks from climate change that UAE-domiciled financial firms are encouraged to incorporate into their disclosures for effective governance and risk management.

Outlook and conclusions

The upcoming publication of the DIFC Sustainable Finance Framework and of the UAE taxonomy are hotly anticipated. They will bring the UAE one step closer to a fully comprehensive sustainable finance framework to address the upcoming challenges of the next decade and beyond.

Moving forward, developing funding initiatives and introducing sustainable finance incentive mechanisms would entice the private sector to embark on the journey of energy efficiency, renewable energy and green technology. It is hoped that in the UAE, a combination of favourable (and sometimes innovative) regulatory landscape, government and state-owned investors leading by example and mounting investor and market pressure will encourage behaviours that hasten the energy transition, consistent with the UAE's stated goals of achieving net zero carbon emissions and the SDGs. This would have the added positive effect of further diversifying the UAE's economy, while also creating jobs across multiple sectors in the process.

Endnotes

1 Chris Macbeth is a partner, Daniela Weerasinghe and Misthura Otubu are associates and Kay Hechaime is an international lawyer at Cleary Gottlieb Steen & Hamilton LLP. The information in this chapter was accurate as at 27 November 2023; at the time of writing, COP28 is taking place in the UAE, and developments are constant. ^ Back to section

2 See https://uaeyearof.ae/. ^ Back to section

3 See https://www.sca.gov.ae/Content/Userfiles/Assets/Documents/29e6ef1d.pdf. ^ Back to section

4 See https://www.clearygottlieb.com/news-and-insights/publication-listing/an-innovative-sustainable-finance-regulatory-framework-takes-shape-in-the-abu-dhabi-global-market. ^ Back to section

5 The EU PAB tracks companies that are on track to reduce their carbon emissions by 50 per cent compared to companies in their parent index basket, and 7 per cent year-on-year. ^ Back to section

6 A climate transition taxonomy is a classification system of economic activities that are not currently zero or near-zero emitters of greenhouse gases, but that assist with the transition towards an economy with lower carbon emissions or more environmental sustainability. ^ Back to section

7 Only bonds and*sukuk* issued under third party frameworks and subject to external review are eligible. ^ Back to section

8 Third party metrics should be used to measure the progress of those assets achieving sustainability objectives. Progress against those metrics should be disclosed to investors periodically, including in the annual report. ^ Back to section

9 This should focus on entities whose net zero greenhouse gas emissions targets have been verified by the Science-Based Targets initiative (SBTi). ^ Back to section

10 See https://www.clearygottlieb.com/news-and-insights/publication-listing/an-innovative-sustainable-finance-regulatory-framework-takes-shape-in-the-abu-dhabi-global-market. ^ Back to section

11 See https://www.clearygottlieb.com/-/media/files/alert-memos-2023/2023_02_24-gcc-launches-unified-sustainability-disclosure-metrics.pdf, page 1. ^ Back to section

12 See https://www.clearygottlieb.com/-/media/files/alert-memos-2023/2023_02_24-gcc-launches-unified-sustainability-disclosure-metrics.pdf, page 2. ^ Back to section

13 See https://adgm.arabsustainability.com/; the 10 ESG disclosure KPIs based on GRI and Sustainability Accounting Standards Board standards can be tracked across Abu Dhabi Sustainable Finance Declaration signatories and GCC Listed Sustainability reporters. They include: (1) community investment as a percentage of pre-tax profit; (2) energy intensity (GJ/employee); (3) whether ESG risks are reviewed at board level; (4) greenhouse gas intensity (tons/employee); (5) the percentage of women at board level; (6) the percentage of women in management positions; (7) the percentage of women in the workforce; (8) whether a sustainability report is prepared; (9) training hours per employee; and (10) the turnover rate. ^ Back to section

14 See https://www.moccae.gov.ae/en/our-sustainable-environment/strategies/uae-renewable-energy-strategy.aspx. ^ Back to section

15 www.moccae.gov.ae/en/our-sustainable-environment/strategies/uae-renewable-energy-strategy.aspx. ^ Back to section

16 See https://u.ae/en/about-the-uae/strategies-initiatives-and-awards/strategies-plans-and-visions/environment-and-energy/uae-energy-strategy-2050. ^ Back to section

17 See UAE Energy Diversification | UAE Embassy in Washington, DC (www.uae-embassy.org). ^ Back to section

18 See https://www.reuters.com/world/middle-east/uaes-revised-energy-strategy-includes-big-hydrogen-plans-2023-07-11/. ^ Back to section

19 See https://www.dewa.gov.ae/en/about-us/media-publications/latest-news/2017/10/world-green-economy-summit-2017-concludes-with-the-announcement-of-the-4th-dubai-declaration. ^ Back to section

20 See https://www.abudhabi.gov.ae/en/programmes/abu-dhabi-industrial-strategy. ^ Back to section

21 See https://www.adgm.com/media/announcements/abu-dhabi-to-launch-first-regulated-carbon-credit-trading-exchange-and-clearing-house-in-the-world. ^ Back to section

22 See https://www.adgm.com/media/announcements/adgm-fsra-issues-enhancements-to-its-capital-markets-framework-including-environmental-instruments. ^ Back to section

23 More Information on Barakah Nuclear Power plant: The direct loan agreements include the overnight cost of the Prime Contract for the construction and commissioning of the Barakah Nuclear Energy Plant, interest during construction and the cost of initial nuclear fuel. They also include allowances for potential inflationary increases in the price of commodities, such as construction materials, during the period of construction. https://www.mediaoffice.abudhabi/en/economy/added-expanded-its-electricity-tariffs-incentive-programme-to-include-smes/; 'UAE secures $24.4bn for its first nuclear power plant', TXF (https://www.txfnews.com/articles/5845/uae-secures-24-4bn-for-its-first-nuclear-power-plant); https://www.apicorp.org/wp-content/uploads/2021/12/Solar-Energy-in-the-UAE-Impressive-Progress.pdf. For further examples of green energy and productivity and efficiency projects and programmes, see also: https://www.uae-embassy.org/discover-uae/climate-and-energy/uae-energy-diversification; https://www.mocd.gov.ae/en/services/apply-for-inflation-allowances.aspx-; and https://www.turnerandtownsend.com/en/projects/shams-1-100mw-csp/. ^ Back to section

24 See https://wam.ae/en/details/1395303133592. ^ Back to section

25 See https://www.thenationalnews.com/business/economy/2023/07/12/uae-finance-ministrys-new-projects-to-boost-countrys-economic-environment/. ^ Back to section

26 See https://www.clearygottlieb.com/news-and-insights/publication-listing/uaes-innovative-climate-risk-principles-expected-to-apply-to-whole-financial-sector. ^ Back to section

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Introduction

The United Kingdom remains subject to a challenging 2050 net zero target and interim greenhouse gas (GHG) reduction targets notwithstanding the government's adjustments to its delivery plans for meeting those targets.[2] The UK is committed to transitioning to a low-carbon economy, and a significant shift in investment towards sustainable projects and green technology is needed to achieve the targets.

The UK government published an updated Greening Finance Strategy in March 2023.[3] The Strategy sets out how the UK will pursue its ambition to become the world's first net zero-aligned financial centre, accelerate the shift to a green global financial system and catalyse green financing globally by equipping the market with the information and tools necessary to drive the transition to a decarbonised economy. The Strategy acknowledges that there remains only 27 years to decarbonise the global economy by 2050 and that this must happen while reversing the decline in nature and adapting to the changing climate. This will require a step-change in levels of investment in the green economy, with an additional £50–60 billion of capital investment required each year to deliver on the UK's net zero ambitions and £44–97 billion of investment over the next 10 years to deliver the UK's nature-related goals. The 2023 update focuses on the biodiversity and nature crisis and is accompanied by a Nature Markets Framework,[4] which describes the government's principles for developing high-integrity markets to enable farmers and land managers to attract investment in natural capital, and the government's plans to develop a comprehensive suite of nature investment standards. The gap between the finance necessary to mobilise the net zero transition and reverse the decline in nature is nevertheless still large. The UK's Climate Change Committee (CCC) remains concerned that the level of investment is inadequate to meet the UK's adaptation needs and considers that several measures are needed to improve adaptation investment.[5] This is a key challenge that the government and financial regulators face in delivering the Strategy.

The significant developments regarding sustainability reporting that took place in 2023 (such as the publication of several new reporting standards) are designed to ensure investors and lenders can rely on robust sustainability data to direct capital flows towards investments that will support the UK's decarbonisation and a recovery of nature (See Section V).

Year in review

The UK is a global leader in sustainable finance and remains the only financial centre that leads in both conventional and green financial centre rankings – with 4 per cent of the total global green bond issuance.[6] In 2023, the market continues to respond to the climate emergency; with £4.5 billion of sustainable bonds issued in 2022.[7] Following the decline in new issuance volumes across the sustainable finance bond markets in 2022, the market is seeing a return to growth in 2023, for example, the volume in sustainability linked bonds (SLBs) is on the rise again following a bumper week of issuances at the start of September.[8]

However, green finance still represents a relatively small proportion of overall financial markets activity in the UK. Approximately half of green finance activity comprises issuances of labelled green bonds (that is, bonds with a green use of proceeds), also referred to as use of proceeds (UOP) bonds (see Section IV). S&P Global Ratings anticipate that sustainable bonds will take a larger share (14 to 16 per cent) of the overall bond market in 2023.[9]

A significant portion of the green bond market is accounted for by the UK government's issuance of £9.9 billion of green gilts in 2022–2023, which will finance infrastructure investment needed to decarbonise the economy and support the recovery of nature in the UK.[10] In September 2023, HM Treasury published its first UK Green Financing Allocation and Impact Report, which details the projects that benefit from this green finance and the climate and nature impacts (e.g., greenhouse gas savings and tree planting) achieved.[11]

Over the past five years, the penetration of green finance has been highest in the bond market, where it represents 12 per cent of all bond issuances in the UK, compared with 7 per cent in the loan market and only 2 per cent in the equity market.[12] Debt markets, primarily green bonds, account for the vast majority of the market in green finance in the UK. The UK still lags behind the European Union in green finance. Despite representing over 20 per cent of all capital markets activity in Europe over the past five years, UK issuers account for only 14 per cent of all green finance in European capital markets over the same period. Green finance accounted for approximately 5 per cent of all capital markets activity in the UK over the past five years, roughly half of the amount in the EU.[13]

The levels of investment in sustainable finance in 2022 fell well short of the amount required for the government, corporates and financial institutions to meet their net zero targets. The estimated annual investment required to support the UK's net zero commitment is approximately £190 billion, almost twice the amount that has been raised over the past five years.[14] Key elements in scaling up the rate of investment in green finance will include more transparency and clarity about definitions of green finance, use of proceeds and companies' adoption of transition plans, each of which forms part of the initial phase of the government's Green Finance Strategy.

In 2023, an increased focus in the market is on transition finance, a concept, described in the OECD Guidance on Transition Finance as 'the dynamic process of becoming sustainable or reaching net zero by financing the higher emitting and harder to abate sectors of the economy as they transition'.[15] In June 2023 the International Capital Markets Association (ICMA) published Climate Transition Finance Handbook,[16] which provides guidance to enable financing for issuers wishing to address 'issues inherent to climate change' whether through the use of proceeds instruments or sustainability-linked instruments (see Section IV).

Regulation and policy

Although the UK is committed in law to achieving net zero by 2050, current frameworks for sustainable finance and ESG reporting are primarily voluntary. The government's Green Finance Strategy, published in 2019 and updated in 2023, seeks to build a regulatory framework and establish mandatory guidelines for green labelling, sustainability reporting and taxonomies in order to provide investors with more clarity regarding green finance.

The government's objectives under the Strategy are to:

1. align: enable the market to align with UK climate and environmental goals; and

2. invest: mobilise and create opportunities for green investment.

A number of initiatives have been proposed or implemented to address the availability, quality and consistency of sustainability information for investors. These initiatives include, among others, consulting on the implementation of the Sustainability Disclosure Requirements (SDRs), and delivering a UK Green Taxonomy that is fit for purpose and useful as a marketing tool. Other proposals are being considered that will support these initiatives, such as the government proposal to regulate the provision of ESG rating providers.

On 28 November 2023, the Financial Conduct Authority (FCA) confirmed the long-awaited final rules and guidance for UK asset managers aimed at improving the trust and transparency around sustainable investment products through the launch of the SDR labelling regime. The FCA also published a guidance consultation in relation to the anti-greenwashing rule, which will come into effect on 31 May 2024.

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i Governance regime

In terms of the financial regulators' focus on sustainability, the Prudential Regulation Authority (PRA) has historically considered the key issue as climate risk, requiring a named individual at board level within banks and investment firms to be responsible for identifying and managing financial risks from climate change. The FCA, on the other hand, has been more focused on requiring disclosures, described above, notably TCFD reporting for listed companies and certain asset managers and asset owners as well as their recent proposals around a SDR labelling regime. The FCA has started to explore policy options around governance, incentives and competence in relation to sustainability through a recent discussion paper, but no specific proposals have been released.

ii Regulators

The FCA and PRA have authority to oversee and enforce compliance with their respective requirements. It is likely that following the introduction of the anti-greenwashing rule, the FCA may use its investigatory and enforcement powers to take action under this new rule.

Other regulators have general powers that can be exercised with respect to disclosures or marketing materials related to sustainability. The Advertising Standards Authority, for example has recently taken action against HSBC, imposing a financial penalty for posters in bus stops during a marketing campaign to coincide with COP26, which the regulator said omitted significant information about HSBC's contribution to carbon dioxide and greenhouse gas emissions.

Sustainable finance instruments

The term sustainable finance is generally used to refer to a range of financial products connected to ESG aims, which include green, social, sustainable and sustainability-linked financial products, as set out below. The labels attached to financial products describe the type of projects or activities that are financed or benefits captured. Green, social, sustainable and sustainability-linked financial products are the most common financial products in the UK market. However, market innovation is leading to greater stratification as new products and labels emerge, with the most common types of sustainable finance instruments described below:

1. green: financial instruments whose proceeds are used exclusively to finance or refinance green projects or projects with clear environmental benefits. Also referred to as 'labelled green' products or 'UOP' products. The UOP should be verifiable against the issuer's public disclosure documents;
2. social: financial instruments whose proceeds are used exclusively to finance or refinance eligible social projects, as defined by the relevant international standards. The UOP should be verifiable against the issuer's public disclosure documents;
3. sustainable: financial instruments whose proceeds are used exclusively to finance or refinance any combination of eligible green and social projects, as defined by the relevant international standards. The UOP should be verifiable against the issuer's public disclosure documents; and
4. sustainability-linked: forward-looking performance-based financial instruments in which the issuer commits to future improvements in sustainability outcomes within a predefined timeline, in accordance with relevant international standards. These instruments typically include a financial disincentive, such as an interest rate step-up, if the issuer fails to meet the sustainability targets within the predefined timeline (and may sometimes include a financial incentive, such as an interest rate reduction, if the issuer meets the sustainability targets within the predefined

timeline). SLBs and loans are not UOP products: proceeds do not have to be used for a specific purpose and may be used for general corporate purposes.

In recent years, the vast majority of sustainable bond issuance has aligned with the Green Bond Principles, Social Bond Principles, Sustainability Bond Guidelines and Sustainability-Linked Bond Principles (together, the Principles) administered by ICMA, which are voluntary market-based standards. However, in October 2023 the European Council and Parliament adopted a Regulation for an EU Green Bond Standard (the EuGB),[17] which will likely take effect late in 2024. The EuGB will be a voluntary standard open to both EU and non-EU issuers. It provides that at least 85 per cent of the net proceeds of an EuGB offering must be invested in 'environmentally sustainable activities' aligned with the EU Taxonomy requirements with a 'flexibility pocket' available for the balance. In addition, the issuer must publish a prospectus under the EU Prospectus Regulation (Regulation 2017/1129), unless it is an EU sovereign or quasi-sovereign entity, and it must also publish a pre-issuance factsheet (with a report from an independent external reviewer), annual allocation reports (with a report from an independent external reviewer) and an impact report, following full allocation of the net proceeds. Finally, the Regulation outlines that external reviewers must be approved by and registered with the European Securities and Markets Authority (ESMA). While this Regulation will not have the force of law in the UK, it will be open to UK issuers to adhere to this standard. It remains to be seen how popular it will prove to be among UK issuers and investors.

Recent years have also seen an increasing number of green bond issuances focused on the sustainable use of maritime resources and the promotion of related sustainable economic activities with the result that these bonds have come to be recognised as a distinct subset of green bonds, known as 'blue bonds'. In September 2023, ICMA (in conjunction with various international bodies) published a global practitioner's guide for bonds to finance the sustainable blue economy.[18] This guidance views the blue economy as part of the green economy and is meant to be used in conjunction with the Principles, affording guidance on how UOP bonds or SLBs can be used to finance projects supporting the sustainable blue economy and ocean health. Although this guidance focuses on bonds, it may also be applicable to other debt instruments such as loans.

Finally, a categorisation of transition bonds is also coming to be recognised in some quarters. Transition bonds are not strictly 'green' but have a role to play in decarbonising an activity or supporting an issuer in its transition to align with the Paris Agreement 1.5 degrees goal. Proceeds are not tied to specific projects or assets but are intended to support the improvement of the issuer's sustainability performance. Having first emerged in 2017, transition bonds have been overshadowed by the emergence of other types of green finance, such as green bonds and SLBs. Transition bonds largely originate from high polluting sectors and hard-to-abate industries such as mining, steel and cement, aviation and shipping. These sectors have found accessing conventional green finance hard to achieve given the increased taxonomy-based alignment. With the increasing prospect of litigation risk and 'greenwashing' (see Section XI), some market commentators predict an uptake in the issuance of transition bonds in the future.

Sustainable disclosure requirements and taxonomy

i SDRs

Various international, government and regulatory bodies have already taken steps towards formalising disclosure requirements and guidelines regarding green finance. In November 2020, the Chancellor of the Exchequer announced that the UK would make disclosures aligned with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) mandatory across the UK economy by 2025 with most requirements in place by 2023.

TCFD-aligned disclosures are required for financial years beginning on or after 1 January 2021 for premium-listed issuers, on or after 1 January 2022 for standard-listed issuers and larger firms (i.e., those with more than £50 billion in assets under management for asset managers, or £25 billion in assets under administration for asset owners) and on or after 1 January 2023 for firms with over £5 billion is assets that are under management or administration. In the lead up to mandatory reporting, the government recommends that organisations seeking to report on forward-looking financial risks and opportunities arising from climate change should consider reporting in line with the TCFD recommendations on a voluntary basis. The FCA is very focused on transparency and has placed TCFD recommendations at the heart of its work on climate-related disclosures.

In his Mansion House speech in July 2021, the Chancellor of the Exchequer announced new SDRs that will build on the UK's TCFD implementation. Following the FCA's November 2021 discussion paper (DP21/4), on 25 October 2022 the FCA published its consultation (CP22/20) on the SDRs and investment labels for the UK market. These significant proposals aim to provide greater clarity and harmonisation on the rules for products that are marketed as sustainable in the UK. There will be sustainable investment labels and extensive disclosure requirements. There is no obligation or requirement to use the labels for a financial product; however, for those that do not choose to use the labels there will be naming and marketing restrictions that will apply, which will limit how a product can be described with respect to sustainability factors. The FCA is proposing the following three labels:

1. Sustainable Focus: products that invest predominantly in assets that can be deemed to be sustainable;
2. Sustainable Improvers: products that aim to improve the sustainability of their portfolio over time; and
3. Sustainable Impact: products that seek to achieve impact through the provision of finance, typically to underserved markets.

These are mutually exclusive and will have a simpler description on consumer-facing documents. The FCA has provided a framework for determining how products fall within each of these labels. Firms that meet the above criteria for investment products will be able to use icons showing the relevant sustainability label and provide details where disclosure materials about the product can be found. Once a product's label has been determined, certain prescribed disclosures will be required.

The follow up to the consultation paper has been significantly delayed but is widely expected before the end of 2023.

It is expected that there will be considerable interoperability between the SDRs and the International Sustainability Standards Board (ISSB) standards, which were published in 2023 and comprise: IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 Climate-related Disclosures.[19] The Financial Reporting Council (FRC) consulted in 2023 on UK endorsement of IFRS S1 and S2.[20]

The ISSB standards build on the four pillars of climate-related financial disclosure developed by the TCFD: governance, strategy, risk management, and metrics and targets. The SDRs are expected to go further in requiring disclosure against the UK's Green Taxonomy (See Section Viii). In particular, asset managers and owners and developers of investment products will be required to substantiate their ESG claims in a way that is accessible to clients and consumers and that allows them to compare one product with another. They will also be required to disclose whether and how they take ESG-related matters into account in their governance arrangements, investment policies and strategies.

The framework of the UK SDRs

	Corporates	Asset managers/owners	Investment products
Governance in relation to sustainability-related risks, opportunities and impacts	Governance in relation to sustainability-related risks, opportunities and impacts, and the implications for investment policies, strategies and outcomes	Governance in relation to sustainability-related risks, opportunities and impacts, and the implications for investment products	
Actual and potential implications of sustainability-related risks, opportunities and impacts for the organisation's businesses, strategy and financial planning	Actual and potential implications of sustainability-related risks, opportunities and impacts for the organisation's investment policies, strategies and outcomes	Actual and potential implications of sustainability-related risks, opportunities and impacts for investment outcomes	
Processes used to identify, assess and manage sustainability-related risks, opportunities and impacts	Processes used to identify, assess and manage sustainability-related risks, opportunities and impacts, and the implications for the organisation's investment policies, strategies and outcomes	Processes used to identify, assess and manage sustainability-related risks, opportunities and impacts at product level	

Metrics and targets used to assess and manage relevant sustainability-related risks, opportunities and impacts Performance against targets Taxonomy alignment and relevant supporting information	Metrics and targets used to assess and manage relevant sustainability-related risks, opportunities and impacts, and implications for the organisation's investment policies, strategies and outcomes Performance against targets (where relevant) Taxonomy alignment and relevant supporting information based on underlying investments	Product-level metrics and performance indicators on sustainability-related risks, opportunities and impacts Performance against targets (where relevant) Product-level Taxonomy alignment and relevant supporting information based on underlying investments	
Source: Greening Finance: A Roadmap to Sustainable Investing (-publishing.service.gov.uk)			

ii Transition plans

In 2023, the UK's Transition Plan Taskforce (TPT) issued its Disclosure Framework[21] and Implementation Guidance together with a suite of documents including a comparison with other reporting standards. Sector-focused guidance for 40 sectors has been published for consultation and will be followed by deep dives on certain sectors later in 2023. The Disclosure Framework, which builds on both the TCFD recommendations and also the Glasgow Financial Alliance for Net Zero (GFANZ) guidance on transition plans (TPs) for financial institutions,[22] provides guidance to organisations preparing TPs on what should be disclosed. The UK government committed at COP26[23] to make publication of TPs mandatory for large public and private companies and some financial sector firms as a key part of its commitment for the UK to become the world's first net zero-aligned financial centre and ensure that financial flows shift towards supporting a net zero economy. Following the publication of the TPT's Disclosure Framework, it is anticipated that the UK government will consult in the fourth quarter of 2023 on making the production and disclosure of TPs mandatory.

The FCA announced that it welcomes the launch of the Disclosure Framework and intends to consult in 2024 on TP disclosures by listed companies, asset managers and FCA regulated asset owners in line with the Framework, alongside its consultation on implementing UK-endorsed ISSB sustainability disclosure standards..[24] As several organisations around the world worked with the TPT to develop its Framework, it is likely that the Framework will also be used in, and adopted by, other jurisdictions.

iii UK Green Taxonomy

To combat greenwashing and provide more consistent and comparative information to support investor decisions, the government is considering implementing a UK Green Taxonomy (the Taxonomy), which will clearly set out the criteria that specific economic activities must meet to be considered environmentally sustainable and therefore Taxonomy-aligned. Reporting against the Taxonomy will form part of the SDRs. Certain companies will be required to disclose what proportion of their activities is Taxonomy-aligned, and providers of investment funds and products will have to do the same for the assets they invest in. The goals of the Taxonomy are to:

1. create clarity and consistency for investors so that they will be able to easily compare the environmental performance and impact of companies and investment funds to inform their financial decisions;
2. improve understanding of companies' environmental impact and their contribution to environmental sustainability; and
3. provide a reference point for companies. The Taxonomy will provide companies with an informative performance target. For example, companies can also, on a voluntary basis, use the Taxonomy to develop and communicate their net zero transition and capital investment plans.

The Taxonomy has six environmental objectives:

1. climate change mitigation;
2. climate change adaptation;
3. sustainable use and protection of water and marine resources;
4. transition to a circular economy;
5. pollution prevention and control; and
6. protection and restoration of biodiversity and ecosystems.

Each of these objectives will be underpinned by a detailed set of standards known as technical screening criteria (TSC). Each economic activity included in the Taxonomy will have an individual TSC that identifies how that activity can make a substantial contribution to the environmental objective. To be considered Taxonomy-aligned, an activity must meet three tests:

1. it makes a substantial contribution to one of the six environmental objectives;
2. it does no significant harm to the other objectives; and
3. it meets a set of minimum safeguards.

Taxonomy alignment will be based on reported data, rather than projections, in order to provide a clear picture of the areas in which a company is currently making a substantial contribution to environmental objectives. The Taxonomy also allows for recognition of companies that, while not currently conducting their business in a way that is aligned with net zero ambitions due to technological constraints, are engaged in transitional activities (such as aligning with best-in-sector emissions levels) or are investing capital expenditure in activities that are Taxonomy-aligned, or both. The Taxonomy will also recognise enabling activities, which support contributions to environmental objectives but are not yet sustainable themselves (such as the manufacture of components for wind turbines).

ESG data, ratings and reporting

Despite changes to the UK regulatory structure to implement a suite of reporting requirements regarding ESG, standards for raising green finance remain primarily voluntary. Labelled green bonds and loans are often aligned with the ICMA Green Bond Principles or the Loan Market Association (LMA) Green Loan Principles, as relevant, which are voluntary standards built upon four pillars: (1) UOP; (2) process for evaluation and selection of eligible projects; (3) management of proceeds; and (4) reporting. Similar standards exist for sustainability-linked, social and sustainable loans and bonds. Although issuers of green finance often choose to report against these principles, this reporting is not currently mandatory, and investors generally have no recourse against issuers that do not use proceeds as anticipated, fail to achieve sustainability targets or fail to provide a particular level of ongoing disclosure.

Many sustainable finance issuers rely on second party opinions, which are obtained from third-party ESG ratings organisations to confirm the alignment of the issuer's relevant sustainable financing principles with the ICMA or LMA standards or to confirm the alignment of the particular issuance with the issuer's sustainable financing principles, or both. Currently, these ESG ratings organisations are not regulated, and there are no standard guidelines on the level of diligence required to deliver such opinions. In 2023, the government indicated[25] that it is considering bringing ESG ratings providers within the scope of FCA authorisation and regulation, a proposal that is supported by the FCA.

Sustainable finance incentives

A market-led transition will require listed companies and regulated firms to have the right incentives, tools and organisational arrangements in place to set and pursue effective ESG strategies, including TPs aligned with the government's net zero targets. A number of market-led initiatives have developed in the UK to support companies and financial institutions in their independent efforts towards sustainability and to coordinate these efforts across the economy. For instance, the Green Finance Institute (GFI)[26] was established in 2019 as a public and private sector coalition of global financial industry experts that is focused on designing, developing and launching portfolios of scalable financial solutions that accelerate sector-specific transitions to a low-carbon economy and nature positive outcomes. Other groups have also been established, such as the Glasgow Financial Alliance for Net Zero (GFANZ),[27] which unites net zero financial sector-specific alliances from around the world in one industry-wide strategic alliance and provides a forum for leading financial institutions to accelerate the transition to a net zero global economy. The GFANZ Secretariat recently launched a consultation on its work to further refine the definitions of its transition finance strategies and support financial institutions to forecast the impact of these strategies on reducing emissions.[28]

More recently, however the FCA has published a new discussion paper titled 'Finance for positive sustainable change: governance, incentives and competence in regulated firms'.-[29] The paper explores ideas from the regulator (as well as a series of essays from third parties) on how firms could integrate 'sustainability' in their governance, executive accountability and remuneration frameworks to encourage individuals' and enterprise investment into supporting the wider transition to net zero. It is not clear what the FCA's next steps will be following the paper or whether they will lead to specific proposals in these areas, but it certainly shows that the FCA expects firms to act in a considered manner even in the absence of such rules.

Carbon markets and carbon trading

In the UK, mandatory carbon credits arrangements are implemented through the UK Emission Trading Scheme (UK ETS).[30] The UK ETS is a cap and trade[31] scheme that aims to reduce GHG emissions by imposing obligations on operators in certain energy-intensive sectors[32] through the concept of emission allowances (UKAs).[33] UKAs are either auctioned or allocated for free to eligible installation and aircraft operators and are tracked and recorded through the UK Registry.[34] UKA trading takes place either over the counter (OTC) or via organised exchanges. Transactions in the secondary market will also give rise to a transfer on the Registry[35] through UK ETS trading accounts and compliance accounts.[36] UKAs are financial instruments under UK MiFID II,[37] so trading in UKAs is a regulated activity requiring financial services licensing for participants other than operators.

Voluntary carbon credits (VCCs)[38] are issued by private independent entities, not government or regulatory bodies, and the market is therefore largely self-regulated. In particular, VCCs do not constitute financial instruments under UK MiFID II, so trading them does not require financial services licensing. While both the projects and the independent third parties that validate and verify the projects and the VCCs they generate are primarily located in emerging markets, UK companies are increasingly interested in investments in such projects and related VCCs.

While the UK ETS was necessitated by the UK's departure from the EU and is therefore comparatively new,[39] it is closely based on the EU ETS, which is one of the longest standing and most developed mandatory emission trading scheme. The UK ETS Authority intends to broaden the scope of UK ETS to include shipping from 2026 and waste incineration and energy from waste from 2028.[40] Secondary market trading in emissions allowances and related derivatives is likely to increase due to the progressive limitation of supply of emission allowances through free allocations and auctions.[41]

Currently, the UK ETS is not linked to other third-country schemes. Linkage would allow for a larger pool of operators and render pricing more efficient[42] and, in the case of the EU ETS, could ensure that UK exports to the EU of high-carbon products are fully exempt from EU's carbon-border adjustment mechanism (CBAM).[43]

Carbon leakage[44] is also a challenge for UK operators. In March 2023, the UK government published a consultation on potential policy measures to mitigate carbon leakage risk and support decarbonisation of UK industry. One of the options explored in the consultation is the development of a UK CBAM. The consultation timeline indicates the earliest potential introduction of a UK CBAM in a limited number of sectors would be 2026, which is in line with UK ETS reforms on free allowances, and the implementation of the EU CBAM levy.

There is ongoing debate as to whether the use of VCCs to meet corporate GHG targets and therefore carbon neutrality claims, could amount to greenwashing (see Section XI). The projects that qualify and the due diligence of these projects will continue to raise difficult issues, but the more those markets can coalesce around globally recognised standards for high quality credits and develop and maintain robust registry and trading platforms and verification and validation processes, the more likely it is that greenwashing concerns will abate.[45] The UK's 2023 Green Finance Strategy confirmed that the UK government would be consulting before the end of 2023 on the interventions required to support the development of high integrity voluntary carbon markets.[46]

Green technology

Data and emerging technologies such as artificial intelligence (AI) have huge potential to provide solutions to ESG concerns, from combating greenwashing to expanding access to a wider range of financial products, but access to relevant data is the key enabler. To this end, in August 2023 the FCA made its Digital Sandbox[47] permanently available following successful pilots. The sandbox provides innovators with access to hundreds of high-quality consumer and market datasets, allowing them to experiment through proof of concepts, collaborate with others and showcase ideas to any interested party, including regulators. The sandbox is focused on digital solutions that make ESG-related disclosures more transparent and help consumers understand the ESG profile of the products and providers they use.

Furthermore, the UK's 2023 Green Finance Strategy recognised the need to accelerate the use of climate and environmental data and analytics by financial institutions, for which the UK Centre for Greening Finance and Investment (CGFI)[48] was established. The CGFI makes available open tools and datasets including the CFRF Climate Narrative Tool, designed to support firms in assessing their climate-related risks and opportunities. The CGFI will now broaden its scope to develop data and analytics best practice, guidance and standards through its innovation hubs.

Climate change, nature and biodiversity impacts

During 2023, there were important changes that impact how companies manage climate and nature-related impacts. In particular, there were several significant additions to the sustainability disclosures ecosystem including publication of the ISSB's first sustainability reporting standards (SDSs) and the TPT's Disclosure Framework (see Section V). The European Commission published a Delegated Regulation and accompanying Annexes setting out the first 12 European sustainability reporting standards (ESRSs) that will enable the disclosures required under the Corporate Sustainability Reporting Directive (2022/2464) (CSRD).[49] This is relevant to non-EU entities that are in scope of the CSRD (for example, where they have a subsidiary or branch in the EU that meets the relevant thresholds).

The assessment, management and reporting of nature-related dependencies, impacts, risks and opportunities by companies is an area that has also seen significant development in the past couple of years. Building on the work of the TCFD and the changes in the corporate world's management and reporting of climate-related risks and opportunities (CROs), the Taskforce on Nature-related Financial Disclosures (TNFD) has published disclosure recommendations and accompanying guidance.[50] The TNFD aims to ensure that nature-related risks are treated as a strategic management issue by companies. It also aims to encourage a shift in global financial flows away from nature-negative outcomes, by companies providing clear, comparable and consistent information on material nature-related risks and opportunities (NROs). The TNFD recommendations are voluntary, and businesses are encouraged to register as TNFD adopters. It is anticipated that the TNFD recommendations will be mandated by individual jurisdictions or reporting standards. The Carbon Disclosure Project (CDP), which runs a global environmental disclosure platform for companies, has committed to align that platform with the recommendations.[51]

In March 2023, the UK government indicated in its Green Finance Strategy that it would explore how the TNFD recommendations should be incorporated into UK policy and legislation.[52] The FCA is also expected to mandate TNFD reporting in the same way as it has for TCFD reporting.

Greenwashing and climate litigation risks

ESG-related litigation continues to increase in frequency and scope, against more diverse corporate actors, and with an ever-increasing variety of legal arguments.[53] This type of litigation continues to gain momentum with emerging challenges, for example, a focus on corporate due diligence and duties, supply chains, greenwashing, derivative claims, fiduciary duties and respect for human rights. In addition, ESG-related litigation against financial institutions is a clear emerging trend.

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i Greenwashing

In May 2023, the European supervisory authorities (ESAs) – consisting of the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and ESMA – published a progress report on greenwashing in the financial sector. In the report, the ESAs put forward a common high-level understanding of greenwashing as 'a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product or financial services. This practice may be misleading to consumers investors or other market participants and may occur or spread either intentionally or unintentionally.'[54]

Despite this proposed definition, there is presently no universally agreed or legal definition of greenwashing. It is an umbrella term that groups together certain types of wrongdoing. It is not, however, a cause of action in its own right.

However, points of commonality are apparent. Greenwashing generally concerns matters based in some form of misstatement or misrepresentation. There are several well-established causes of action or regulatory powers that lend themselves to this type of misstatement, for example:

1. securities litigation under Sections 90 and 90A of the Financial Services and Markets Act 2000 arising from false or misleading statements and disclosures; and
2. tort or common law, such as misrepresentation.

The risk of such claims is multi-faceted, and the same set of facts and allegations may draw attention from regulatory authorities, NGOs and private individuals.

As such, there is an increasing risk that climate-related disclosures may become the focus or subject of court litigation, or the subject of regulatory investigations or action, whether by financial regulators, advertising standards authorities[55] or consumer protection authorities. An example is the proposed 'anti-greenwashing' rule to be introduced by the FCA. It will apply to all FCA-regulated firms and require all sustainability-related claims to be clear, fair and not misleading (i.e., proportionate and not exaggerated). The rule is expected to come into effect sometime during the fourth quarter of 2023, albeit this requirement already features in various FCA rules, such as the Principles for Businesses and Conduct of Business Sourcebook.

ii Directors' and fiduciary duties, and derivative claims

Fiduciary duties, and more specifically, directors' duties have also been in the spotlight with regard to climate change, both in this jurisdiction, and further afield. Most notably, there is the derivate action brought by ClientEarth against the directors of Shell plc. On 12 May 2023, the English High Court rejected ClientEarth's application for permission to bring a derivate claim against the directors of Shell plc under the Companies Act 2006 (the Companies Act).[56] ClientEarth's claim was advanced on the basis of breach of Sections 172 and 174 of the Companies Act, which, respectively, impose a duty:

1. to act in a way the director considers in good faith would most likely promote the success of the company, having regard to a range of factors including the impact of the company's operations on the community and the environment. This is a subjective test; and
2. to exercise reasonable care, skill and diligence. This test is both subjective and objective.

ClientEarth was ultimately unsuccessful,[57] and the derivative claim was refused. It illustrated the courts' reluctance to prefer opinions of claimants to the judgement of directors, affirmed the position that climate change risk is to be considered by directors in the context of other considerations and the bar for permission to being a derivation action under the Companies Act is high. Therefore, so far in the UK, the courts have shown a reticence in expanding the boundaries of these duties with respect to climate change. However, the appetite to bring such cases shows no sign of abating, and the risk of these claims and the reputational context are not to be ignored.

All this poses liability risk, which will increasingly need to be incorporated into financial institutions' operational risk management processes and procedures, to take account of the financial impact of possible reputational harm and greenwashing-related financial risk.

Outlook and conclusions

Sustainable finance has enjoyed a substantial rise in popularity over the past few years, attributed to both increasing awareness of climate change and the potential for high investment returns.[58] The industry will come of age over the next few years and with it the regulatory and reporting frameworks around it.

The timeline below sets out some key milestones in the UK's sustainable finance legislation and regulation during 2023 and going forwards.

Sustainable finance has enjoyed a substantial rise in popularity over the past few years, attributed to both increasing awareness of climate change and the potential for high investment returns.[58] The industry will come of age over the next few years and with it the regulatory and reporting frameworks around it.

The timeline below sets out some key milestones in the UK's sustainable finance legislation and regulation during 2023 and going forwards.

Timeline of some key milestones in the UK's sustainable finance legislation

Date	Action
March 2023	UK government Green Finance Strategy updated
March 2023	FCA updates on its Sustainability Disclosure Requirements (SDR) and investment labels consultation
June 2023	Deadline for the first mandatory TCFD reports published under the FCA's rules for asset managers with assets under management (AuM) of more than £50 billion
June 2023	IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information; and IFRS S2 Climate-related Disclosures published.
August 2023	The FCA makes its Digital Sandbox permanently available.
September 2023	ICMA published a guide for bonds to finance the sustainable blue economy

October 2023	The European Council and Parliament adopted a Regulation for an EU Green Bond Standard (the EuGB), which will likely take effect late in 2024.
October 2023	The launch of the 'gold standard' TPT Disclosure Framework.
Fourth quarter 2023	The FCA's consultation paper on the SDRs and investment labels for the UK market is anticipated.
Fourth quarter 2023	It is anticipated the FCA will introduce a proposed anti-greenwashing rule across all regulated firms.
2026	Earliest potential introduction of carbon border adjustment mechanism (CBAM) in a limited number of sectors.
2026	UK ETS to be extended to cover domestic maritime transport sector.
2028	UK ETS to be extended to cover waste (energy from waste & waste incineration) sector.

The key challenges for sustainable finance markets in the UK include:

1. small overall market share: green finance still represents a very small proportion of overall UK financial markets activity;
2. funds not being used to
3. slow transition in the equity markets: the debt markets are becoming greener but the equity markets have been much slower to transition; and
4. greenwashing: marketing that highlights a company's sustainability credentials in a potentially misleading way is becoming a focus in increased regulatory and third party action. Climate litigation will continue to affect the transition costs and risks faced by financial and non-financial entities.

Endnotes

1 Anna-Marie Slot, Lorraine Johnston, Anna Delgado, Alex Biles, Tim Rennie and Kerion Ball are partners, Becky Clissmann is an environmental lawyer, Anna Varga is a counsel, Adam Eskdale is a senior associate and Tim Morris is a consultant at Ashurst LLP. ^ Back to section

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30 The framework for the UK ETS is set out in the Greenhouse Gas Emissions Trading Scheme Order 2020 (SI 2020/1265). The UK ETS replaced the UK's participation in the European Union Emissions Trading Scheme (EU ETS) on 1 January 2021 but the UK ETS actually commenced May 2021 when the first allowances auction took place. ^ Back to section

31 Covered emitters are granted or purchase a number of 'carbon allowances', which permit emissions. Emitters must hold and relinquish allowances for all GHG emissions, or trade and sell their excess allowances to emitters who require more than their allocated amount to cover their emissions. ^ Back to section

32 Including, for example, manufacturing, refineries, power stations and air transport. ^ Back to section

33 An emission allowance represents the right to emit one metric tonne of CO2 equivalent in the atmosphere. ^ Back to section

34 The UK ETS Registry records include allowances held in Operator Holding Accounts (OHA), Aircraft Operator Holding Accounts (AOHA), Trading Accounts and Government Accounts. The UK Kyoto Protocol Registry records include holdings of international units in accounts and international unit transfers. ^ Back to section

35 The secondary market provides market participants with a way to source of allowances outside auctions and free allocation. ^ Back to section

36 UK ETS trading accounts are available for holding and trading UK allowances as activities unrelated to UK ETS compliance. Trading accounts cannot be used for UK ETS compliance but operators can use their compliance accounts to trade. ^ Back to section

37 The Directive on Markets in Financial Instruments (2014/65/EU) amending and recast the Markets in Financial Instruments Directive (2004/39/EC), as transposed into UK law under the Financial Services and Markets Act 2000, as amended (FSMA) and the FSMA (Regulated Activities) Order 2001, as amended (RAO). ^ Back to section

38 Credits used by organisations to meet self-set, internal emission reduction goals. The credits are assessed against independent standards and administered by private organisations. Voluntary credits generally are not able to be used to meet compliance obligations. The majority of voluntary credits are purchased by the private sector typically to meet corporate social responsibility goals. ^ Back to section

39 See footnote 17 above. ^ Back to section

40 Further consultation is required on the approach and details of such inclusions. ^ Back to section

41 As at October 2023, 171 UK ETS trading accounts had been opened. ^ Back to section

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43 The first phase of the CBAM started on 1 October 2023. EU importers of high-carbon products (cement, iron and steel, electricity, etc.) are required to report on the GHG emissions embodied in their imports. From 1 January 2026, EU importers will be required to purchase and surrender CBAM certificates in sufficient quantities to pay for the embodied carbon imported into the EU. While EU importers can take into account foreign carbon pricing mechanisms such as the UK ETS where considered equivalent to the EU ETS, they will still need to comply with the reporting requirements. Full exemptions from the CBAM requirements can be achieved only via the participation in the EU ETS or full linkage with the EU ETS. ^ Back to section

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45 The Taskforce on Scaling Voluntary Carbon Markets (TSVCM) is an international, private sector-led taskforce that aims to grow and consolidate the Voluntary Carbon Markets (VCMs) to support the climate goals of the UNFCCC Paris Agreement. The TSVCM reviewed existing VCMs, identified key challenges (including greenwashing), and presented a blueprint of actionable solutions. The recommendations, published in 2021, included a new independent governance body for the VCMs; a set of core carbon principles setting quality criteria to which a carbon credit and supporting standards and methodologies should adhere; core carbon reference contracts that can be traded on exchanges and improved master agreements that increase the transparency and standardisation of the OTC markets; and consensus on the legitimacy of carbon offsetting and two sets of principles for companies. ^ Back to section

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Introduction

In the United States, a company's decision to engage in sustainable finance is currently voluntary. Companies are generally free to – and do – consider the reputational and financial benefits of doing a sustainable finance transaction when deciding whether to enter or participate in the market. There are industry guidelines for green, social and sustainable bonds and loans and sustainability-linked bonds (SLBs) and loans (SLLs), as published by the International Capital Market Association (ICMA) and the Loan Syndications and Trading Association (LSTA). While these are just that – guidelines – they are increasingly being viewed in the US sustainable finance market as standards or expectations. In addition to market practices and guidelines, the US federal government has introduced rules and regulations specifically related to ESG matters, but until those rules are formalised, existing securities laws – which tend to focus around disclosure – will continue to govern sustainable finance.

Recent trends in sustainable finance in the United States have in part been driven by the current political environment, with lawmakers in some states moving forward to regulate and promote sustainable finance and climate change initiatives and lawmakers in other states taking steps to restrict ESG investments by government bodies and potentially penalise market participants who disfavour companies that do not engage in positive climate change and energy transition steps. The current political environment has resulted in increased scrutiny of ESG investments and sustainable finance products, resulting in an optimistic, but cautious, mood for sustainable finance investors and issuers.

Year in review

2023 was generally a continuation of the 2022 trends in the sustainable finance market in the United States. In 2022, the Securities and Exchange Commission (SEC) announced proposed rules that may affect sustainable finance, but as further discussed in Section III, at the time of writing, those rules have not yet been adopted and are, therefore, not yet in effect. The volume of sustainable finance transactions in 2023 was higher than in 2022 but not at the peak levels of 2021, although there continues to be significant market interest, especially in SLLs and SLBs. The increased political focus on sustainable finance has also resulted in both investors and issuers more carefully evaluating the reputational risks of sustainable finance initiatives.

Regulation and policy

In the United States, one of the significant obstacles to moving forward sustainable finance initiatives and addressing climate change and energy transition issues is the tension between federal government initiatives and state and local government statutes and policies. While the federal government under the Biden administration is working to advance ESG-related enforcement and disclosure initiatives, certain states have passed various anti-ESG legislation. On the other hand, as further discussed below, California recently enacted legislation with significant enhanced climate-related and other ESG reporting requirements. This Section discusses the regulatory landscape concerning ESG matters at the federal level as well as challenges and at the state level and the California legislation.

In the United States, one of the significant obstacles to moving forward sustainable finance initiatives and addressing climate change and energy transition issues is the tension between federal government initiatives and state and local government statutes and policies. While the federal government under the Biden administration is working to advance ESG-related enforcement and disclosure initiatives, certain states have passed various anti-ESG legislation. On the other hand, as further discussed below, California recently enacted legislation with significant enhanced climate-related and other ESG reporting requirements. This Section discusses the regulatory landscape concerning ESG matters at the federal level as well as challenges and at the state level and the California legislation.

i Federal government level

On 4 March 2021, the SEC launched the Climate and ESG Task Force (the Task Force) within the Division of Enforcement. Its aim is to 'develop initiatives to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment'.[2] The Task Force is 'using sophisticated data analysis to mine and assess information for registrants, to identify potential violations including material gaps or misstatements in issuers' disclosure of climate risks under existing rules, and disclosure and compliance issues relating to investment advisers' and funds' ESG strategies'.[3] The Task Force has brought several actions against companies for alleged violations that have been the subject of wide attention and further focused attention on related reputational risks. In addition, on 7 February 2023, the Division of Examinations of the SEC announced its examination priorities for 2023, and ESG was included as one of those priorities.

Under existing laws, the applicable reporting requirements fall into two categories: reporting requirements for issuers and reporting requirements for investment advisers and investment companies.

Reporting requirements for issuers

For issuers, disclosure requirements for SEC registrants are currently principles-based with some specific line item disclosure requirements based on materiality. If something is material to a company, the company needs to disclose it, but companies have some flexibility to determine what is material and what is disclosed. ESG-related information is disclosed in the same way that other information is disclosed, which involves the principles-based materiality disclosure standard. SEC registrants are also subject to the 2010 Commission Guidance Regarding Disclosure Related to Climate Change,[4] which specifies that certain disclosures may not be explicitly referenced in Regulation S-K, but disclosure is required if it is material. For example, the business description, legal proceedings, risk factors and management's discussion and analysis may need to discuss climate change if it is material for a particular company.

The SEC has also made new disclosure proposals, which would shift reporting requirements to prescriptive disclosure for certain ESG matters instead of the principles-based requirements with the goal of achieving consistent and comparable disclosure among SEC registrants. These proposals are discussed below, but at this time, they are proposed rules that have not been finalised and made effective.

SEC Climate Change Disclosure Rules

On 21 March 2022, the SEC issued the SEC Climate Change Disclosure Rules,[5] a 490-page set of proposed rules that would require extensive reporting by public companies of climate change-related disclosures and expand reporting beyond the current materiality standard. The proposed rule draws many aspects of reporting requirements from the Task Force on Climate-Related Financial Disclosures (TCFD). Among other things in the proposed Rules, public companies would be required to report: direct greenhouse gas (GHG) emissions (Scope 1) and indirect GHG emissions from purchased electricity and other forms of energy (Scope 2); and indirect emissions from upstream and downstream activities in a company's value chain (Scope 3), if material, or if the company has set a GHG emissions target or goal that includes Scope 3 emissions.

Among the SEC's proposed rules is a change to Regulation S-X that would require companies to include climate-related disclosures in a note to their audited financial statements, including climate-related impacts on line items in their financial statements. Since this climate-related information would be part of a company's audited financial statements, it would be subject to audit by the company's auditors. The financial statement disclosures would also require the company to include reporting on activities the company is undertaking to mitigate the impact of climate change, such as GHG emission reductions. The proposed rules also include changes to Regulation S-K that require climate change reporting outside the financial statements, including with respect to corporate governance oversight as it applies to climate change. In addition to board oversight, companies would need to disclose management's role in assessing and managing climate change risks. There are a number of other reporting requirements that companies will need to complete under the proposed SEC rules. The comment period for the proposed SEC rules initially ended on 20 May 2022, but was subsequently extended to 17 June 2022 and, due to a technical glitch, was further extended to 1 November 2022. While the comment period has ended, around 16,000 comment letters were submitted, and as at the time of writing, the SEC has not issued the formal climate-related disclosure rules. The SEC frequently changes rules from the initial drafts following the comment period, so it remains unclear what the final rules will be as well as the timeline for implementing those rules.

Reporting requirements for investment advisers and investment companies

Currently, asset managers are required to disclose material information about a fund to investors and potential investors. Investment companies are also subject to Rule 35d-1 under the Investment Company Act of 1940 (commonly referred to as the Names Rule),-[6] which prohibits investment companies from using materially deceptive or misleading names. Currently, if a registered investment company's name suggests that it makes investments of a certain type, under the Names Rule, the company must invest at least 80 per cent of the value of its assets in investments of that type. Neither of these rules is specific to ESG reporting, but the SEC has proposed two new rules for asset managers and funds that specifically concern ESG, each of which is further described below.

ESG Disclosure Proposal

On 25 May 2022, the SEC announced the ESG Disclosure Proposal, which is a proposed rule that would require enhanced disclosure by investment funds and advisers regarding ESG.[7] The proposed rule would require investment funds and advisers that claim to consider ESG factors to disclose in their prospectuses and annual reports the ESG factors they consider as well as their strategies, specific ESG criteria and data. It would also require certain ESG funds to disclose ESG metrics they consider such that a fund that considers GHG emissions in its investment decisions would have to disclose the GHG emissions of the companies in its portfolio. The proposed rule provides for a standard table for ESG funds to disclose information, which would allow investors to more easily and efficiently compare data across ESG funds.

The amount and type of disclosure by funds and advisers varies depending on the degree to which ESG factors into the fund's strategy. The proposal identifies three types of funds: (1) integration funds (which incorporate both ESG and non-ESG factors in their investment decisions and would be required to disclose how ESG plays a role in their investment criteria); (2) ESG-focused funds (for which ESG factors are a significant focus of their investment decisions and would be required to submit detailed disclosures, including information about their strategies, impacts they are pursuing and any inclusionary or exclusionary screens they are using); and (3) impact funds (which are a subset of ESG-focused funds, and pursue a specific ESG-related impact and would be required to disclose how they measure progress and a summary of progress toward achieving their stated ESG goals).

The comment period for these proposed rules ended on 16 August 2022, and final rules have not yet been issued.

Proposal to amend the Names Rule

The SEC has also proposed changes to the Names Rule.[8] As it currently exists, the Names Rule requires certain funds to invest 80 per cent of their assets in investments that align with the name of the fund. The proposed changes to the Names Rule would amend it so that it applies to funds that have names that imply the fund focuses on investments that have certain characteristics. A fund that has 'ESG', or any other ESG-related term, in its name would be subject to the Rule because inclusion of these terms in the name suggests that the fund makes decisions based on ESG factors. Under the proposal, funds would have to define the terms used in their names; a fund that uses ESG factors, along with other non-ESG factors, where the ESG factors are not relied on more heavily than the non-ESG factors, would not be able to use 'ESG' in its name.

In addition to the SEC's proposed rules and formation of the Task Force, in 2021 the SEC announced an 'all agency' focus on ESG, including in the SEC's Division of Examinations. Various other federal agencies have made statements or taken other actions demonstrating the Biden administration's commitment to addressing climate change. For example, in September 2022, the board of governors of the Federal Reserve System announced that it would conduct a climate scenario analysis exercise with six of the largest US banking organisations. On 24 October 2023, US federal banking regulators finalised principles targeted at the largest banks for the management of climate-related financial risks. While those principles do not have the force of law, they do provide common expectations to be used in bank examinations. In June 2022, the US Commodity Futures Trading Commission released a request for information on how climate-related financial risk is related to the derivatives markets and underlying commodities markets.

ii State government level

States also enact ESG laws, and, California in particular has chosen to wield its influence as one of the largest economies in the world to bring more transparency and accountability to climate-related and other ESG disclosures. On 7 October 2023, California enacted three laws addressing these disclosures.

The three California laws are the Climate Corporate Data Accountability Act, which concerns GHG emissions disclosures, the Climate-Related Financial Risk Act, which concerns climate-related financial risk disclosures, and the Voluntary Carbon Market Disclosures Act, which seeks to regulate claims and other aspects of the voluntary carbon market. However, unlike similar EU legislation, none of these laws has extraterritorial effect.

Climate Corporate Data Accountability Act (SB253)

In order to be subject to this law, covered companies must be entities organised in the US (whether public or private, and regardless of where headquartered) and have annual global revenues of more than US$1 billion. More than 5,000 companies are expected to be subject to this law.[9] The law imposes requirements on covered companies to disclose their GHG emissions from Scope 1, 2, and 3 sources in accordance with the Greenhouse Gas Protocol and to obtain verification from an independent third party assurance provider for GHG emissions. The law also requires implementing regulations that are expected to provide greater detail and interpretative certainty in some key areas to be adopted by 1 January 2025.

Covered companies must begin making required Scope 1 and Scope 2 disclosures in 2026, and Scope 3 disclosures in 2027, and annually thereafter. These disclosures must be provided to and made through a reporting agency, and must be accompanied by an annual fee to cover the cost of administering and implementing the law. Administrative penalties for non-compliance or late filing may be up to US$500,000 per report year.

Climate-Related Financial Risk Act (SB261)

In order to be subject to this law, covered companies must be entities organised in the US (whether public or private, and regardless of where headquartered) and have annual global revenues of more than US$500 million. More than 10,000 companies are expected to be subject to this law,[10] although exclusions apply for insurance companies. The law imposes requirements on covered companies to disclose their climate-related financial risk and measures taken to reduce and adapt to that risk, with the disclosures to be made in accordance with the recommendations of the TCFD or similar reporting standards.

Covered companies must make the required disclosures no later than 1 January 2026, and every two years thereafter. These disclosures must be made publicly available on the covered company's website, and must be accompanied by a reporting agency annual fee to cover the cost of administering and implementing the law. Administrative penalties for non-compliance or late filing may be up to US$50,000 per report year.

Voluntary Carbon Market Disclosures Act (AB1305) (VCMDA)

This law, which appears to have received less publicity than the above two laws (i.e., SB253 and SB261), is seen as one of the first US laws to regulate the voluntary carbon market. It aims to address the problem of 'greenwashing' by requiring companies to make detailed and publicly available disclosures when they make certain climate-related claims (e.g., achievement of 'net zero' emissions or significant reduction in GHG emissions) or use, purchase or sell voluntary carbon offsets (VCOs) in California.

The VCMDA, which takes effect on 1 January 2024, will require covered companies to make disclosures on their websites relating to, as applicable, the VCOs they use (including any independent verification of the VCOs), the VCOs they sell and the climate-related claims they make (including the support for these claims). This disclosure must be updated annually, and failure to comply with the law may result in penalties being assessed on a per-violation (up to US$500,000 per violation) and per-day (up to US$2,500 per day) basis.

While there is some ambiguity over certain definitions used in the VCMDA (e.g., the scope of 'making claims' or 'operating' in California), the law represents a significant development in the voluntary carbon market and underscores California's initiative in seeking to address risks around 'greenwashing'.

Given the broad scope of all three of these recent California laws, it is expected that they will have a material impact on companies operating in California as well as on the investment decisions and financial products that covered companies support. In addition, by providing enhanced transparency in the market, investors are expected to have better tools available to make informed decisions about which projects and programmes to support that, for example, provide for reduced GHG emissions or achieve 'carbon neutrality'.

In contrast to California, the recent trend of initiatives in some state governments is viewed as 'anti-ESG'. For example, a Texas statute was passed that prohibits state investment in financial companies that do not invest in certain energy companies (e.g., fossil fuel) based on ESG metrics.[11] Various states have limited or are seeking to limit or prohibit ESG considerations when investing state funds. Those states include Florida, Texas, Oklahoma, Kentucky, Ohio, Arizona, Idaho and West Virginia. The laws passed in these states are representative of the different types of anti-ESG legislation taking hold in some parts of the United States. That legislation generally tends to take three forms:

1. legislation that prohibits state agencies from doing business with financial companies that do not invest in certain industries for ESG reasons. This legislation often focuses on industries that are important to a particular state's economy, such as fossil fuel production, mining and certain types of agriculture. States justify this legislation on the basis that their citizens are harmed by the ESG-driven non-investment as significant to the state's economy;
2. legislation that prohibits use of state funds for ESG investments, in which people who enter into contracts on behalf of the state or invest funds on behalf of state entities (such as pension funds) are prohibited from doing so with companies that

are deemed to 'discriminate' against certain companies because of ESG concerns; and

3. states sometimes frame anti-ESG legislation less directly, such as, for example, by passing laws or regulations that specify that a state agency can only make investment decisions for the purposes of maximising returns, which could prevent or limit a state agency from making an investment decision based on ESG factors.

Attorneys general in some states have also taken action against some banks to investigate antitrust and consumer protection law violations arising from those banks' involvement in the United Nations' Net-Zero Banking Alliance. The full impact of state anti-ESG measures has yet to be seen, but the anti-ESG wave creates uncertainty as to whether meaningful change can be achieved through sustainable finance in the United States.

Sustainable finance instruments

In the United States, green, social and sustainable bonds and loans, and SLBs and SLLs, are supported. The key defining feature of a green, social or sustainable bond or loan is that the proceeds must be used for green, social or sustainable projects. In contrast, SLLs and SLBs do not have to be used for a specific 'green' purpose. Instead, SLLs and SLBs are used to incentivise the borrower to achieve certain predetermined sustainability goals. Green, social and sustainable loans and bonds are also expected to meet certain criteria with respect to project evaluation and selection, management and reporting of the use of proceeds. On the other hand, SLBs and SLLs should include key performance indicators (KPIs) and sustainability performance targets (SPTs) consistent with the sustainability-linked loan principles (SLLPs) published by the APLMA, LMA and LSTA. The SLLPs specify that KPIs should be 'relevant, core and material to the borrower's overall business' and should be measurable on a consistent basis. The SPTs should be ambitious, which means that they should 'represent a material improvement in the respective KPIs and beyond a “business as usual” trajectory'. When determining KPIs and SPTs, lenders and borrowers face the challenge of ensuring that the KPIs and SPTs remain ambitious for the borrower following a change in the borrower's circumstances, such as following an acquisition or a divestiture, or after a change in law. If a change in law results in the SPTs being the same as the minimum required by law, lenders and borrowers alike should consider whether those SPTs need to be modified, since at that point they are arguably not ambitious. Similarly, lenders should also consider whether the loan documents should include a mechanism for adjusting the SPTs following a material acquisition or divestiture since that acquisition or divestiture could allow the borrower to more easily meet its SPTs than had initially been intended, resulting in the ongoing metrics not being at the intended level of ambitiousness.

Since SLLs and SLBs do not finance a specific green project, lenders and investors in SLLs and SLBs face increasing scrutiny with respect to the loans they are making and whether they are truly moving the needle to advance companies' green initiatives or whether they constitute greenwashing. In SLBs and SLLs, the issuer or the borrower receives a financial incentive for achieving its SPTs with respect to the selected KPIs. To avoid claims of greenwashing, it is increasingly important for lenders to ensure that the KPIs that are selected are material and relevant to the borrower and are sufficient in number to incentivise meaningful change by the borrower. Similarly, the SPTs need to be ambitious and meaningful. When lenders agree to make an SLL, they should be performing diligence on the borrower's business, ESG policies and strategies and reporting, while giving special consideration to the borrower's locations and the nature of the borrower's business. Another key question concerning SLLs and SLBs is whether the financial incentive for meeting the SPTs is sufficient to cause the borrower to change its practices and become more green. If the KPIs and SPTs are set at levels that the borrower can achieve while maintaining business as usual and the financial incentive for making ESG-related changes is not significant for that particular borrower, lenders, as well as borrowers, put themselves at risk for claims of greenwashing.

Another key distinguishing feature of SLBs and SLLs as compared to green bonds and green loans is reporting. Whereas green loans and green bonds require specific reporting as to the use of proceeds for the project, SLLs and SLBs have a more general reporting requirement as to the KPIs and SPTs that should be determined prior to making the loan. Discrepancies in reporting requirements among a company's reports to its lenders, its offering documents, its marketing materials and its corporate sustainability reports can also lead to claims of greenwashing. As scrutiny of SLLs and SLBs increases, it is especially important to ensure that reporting requirements are consistent not just for an individual company but also across all borrowers to ensure SLLs and SLBs that are offered are based on consistent and comparable data. Recently, the LSTA has been working to provide resources to harmonise ESG reporting and diligence questions to achieve the goal of consistent and comparable reporting, particularly with respect to private companies whose ESG strategies and progress are not as widely reported as for public companies and who will also not be subject to enhanced SEC disclosure rules (once those rules are finalised). For lenders and investors, being able to access similar data across borrowers will be especially important as those lenders and investors face heightened reporting requirements with respect to their ESG loans and investments.

In addition to sustainability loan products, social bonds and social loans are also being offered in the United States, although the market for social and governance-focused loan products has not developed as quickly.

Sustainable disclosure requirements and taxonomy

The United States has not adopted the TCFD framework, although the proposed SEC Climate Change Disclosure Rules discussed above are similar in many ways to the TCFD. As noted above, at this time, those rules are only proposed rules and are not yet in effect. The United States has also not adopted a specific taxonomy for ESG disclosures. One of the challenges to adopting a taxonomy in the United States are the multiple federal and state agencies that issue rules and regulations governing disclosures by market participants and the agencies that oversee and take enforcement actions against market participants. Adoption of a uniform taxonomy will require coordination among those agencies.

ESG data, ratings and reporting

As discussed above, the SEC has proposed rules that would require reporting on sustainable investments, but there are not yet any formalised ESG reporting rules on sustainable investments. ESG data reporting requirements for public companies or for ESG funds, other than the general existing reporting rules and regulations, do not yet exist. Coverage of Scope 1, 2 and 3 level emissions in reporting is not yet required.

Sustainable finance incentives

The federal government does not currently offer incentives for general sustainable finance investments (there are some targeted incentives for certain renewable energy and energy transition investments, including carbon capture, sequestration and utilisation, hydrogen and offshore wind). Thus far, those incentives are offered in the private market, such as the interest rate reductions available if the SPTs are met in SLLs.

Green technology

There is currently debate as to the extent to which emerging technologies should be included in sustainable finance investments. As the market expands and a taxonomy for sustainable finance in the United States is developed, there may be greater clarity as to the degree to which emerging technologies, such as hydrogen, ammonia and carbon trading, are influencing sustainable finance.

Climate change, nature and biodiversity impacts

As discussed in Section III, the SEC Division of Enforcement formed the Task Force in March 2021. The formation of the Task Force was a significant step by the SEC toward ensuring that representations in offering materials and other statements by companies, funds and investment advisers are accurate and reflect the actual nature of the ESG investment products. As the proposed rules discussed above have not yet been formalised, the Task Force is currently identifying disclosure and compliance issues related to ESG investments under the SEC's existing rules. There have been a few notable enforcement actions taken by the Task Force in the past few years.

In April 2022, the SEC brought an enforcement action against Vale SA, a Brazilian mining company, alleging material misstatements about dam safety. The SEC's complaint was filed in the US District Court for the Eastern District of New York. It charged Vale with violating antifraud and reporting provisions of the federal securities laws and sought injunctive relief, disgorgement plus prejudgment interest and civil penalties. The complaint alleged that, beginning in 2016, Vale 'deliberately manipulated multiple dam safety audits; obtained numerous fraudulent stability declarations; and regularly and intentionally misled local governments, communities, and investors about the dam's integrity'[12] through Vale's ESG disclosures as well as its SEC regulatory filings. While, ultimately, the Vale enforcement action is about alleged fraud, there is an environmental and social angle that the SEC highlights in its complaint. This case underscores the SEC's attention to ESG disclosures, both in required public filings as well as in voluntary corporate sustainability reports.

In May 2022, the SEC announced that it had charged 'BNY Mellon Investment Adviser, Inc. for misstatements and omissions about Environmental, Social, and Governance (ESG) considerations in making investment decisions for certain mutual funds that it managed'.[13] The SEC's order found that despite BNY Mellon Investment Adviser's statements that all of the investments in the relevant funds had been subject to an ESG quality review, multiple investments in those funds had not undergone the ESG quality review. BNY Mellon Investment Adviser agreed to pay a US$1.5 million penalty to settle the charges. In the SEC's press release announcing the charges, Adam S Aderton, co-chief of the SEC Enforcement Division's Asset Management Unit and a member of the Task Force, said '[a]s this action illustrates, the Commission will hold investment advisers accountable when they do not accurately describe their incorporation of ESG factors into their investment selection process'.[14]

These SEC enforcement actions demonstrate that the Task Force is working to identify misstatements and omissions in ESG disclosures and is willing to take action when it identifies material issues. As noted above, these enforcement actions were based on existing securities rules and regulations. If the SEC's proposed ESG Disclosure Proposal and SEC Climate Change Disclosure Rules are adopted, they will add to the Task Force's ability to take enforcement actions with respect to ESG matters.

In addition to potential SEC enforcement actions, companies also face ESG-related litigation risks from various stakeholders. The groups of potential stakeholders affected by ESG claims is broader than in 'traditional' litigation, which leads to a wider list of potential claimants. Those stakeholders have different goals for the litigation they engage in; some claimants want to affect a company's ESG conduct by encouraging certain behaviours and discouraging others, and other claimants seek to raise awareness of issues. In either instance, litigation can be expensive and result in significant reputational risk for a company.

Outlook and conclusions

While there are certainly challenges in the sustainable finance market in the United States, particularly given the current economic and political climate, there is much to be positive about as demand for sustainable finance products remains strong. Scrutiny of sustainable finance products and the related ESG strategies and claims by issuers will continue to increase. However, the market may see greater uniformity in reporting across companies and ESG-related funds following the issuance of the SEC's proposed rules.

Endnotes

1 J Paul Forrester, Jennifer Kratochvil, Paul de Bernier, and Stephanie Hurst are partners at Mayer Brown LLP. ^ Back to section

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