KPMG

Sustainable finance: it's decision time

From niche product to new business model
Part one of our Sustainable finance series

kpmg.lu

Executive summary

"The green transition will not happen without the financial sector. It is about making sure that our money works for our planet. There is no greater return on investment." Jean-Claude Juncker speaking at the European Commission, Conference on sustainable finance.

Recent history has shown us the impact of taking a short-term approach to finance, with the financial crisis highlighting how a lack of transparency and regulation can create mayhem on a global scale. Governments have launched efforts to prevent similar situations going forward and sustainable finance is an example of an area where it seems they are determined to get it right.

A High-Level Expert Group on Sustainable Finance has been engaged and has created the basis for the EU Action Plan on Sustainable Finance, a blueprint for financial players going forward.

Climate change and other environmental risks now represent some of the most significant global risks both in terms of likelihood and impact. Investor demand is growing and investment processes are being examined through an ESG lens. The cost of taking steps to mitigate the effects of climate change and other ESG-related risks is now lower than the costs that could be incurred by ignoring these risks. Upcoming regulation will move sustainable finance from being an advantage to being a regulatory imperative.

Our report examines why sustainable finance is shifting away from being a niche product to a central pillar of finance and explains why businesses need to consider ESG metrics in their investment decisions and overall business strategy.

We are outlining the challenge posed by environmental risks and the implications of impending regulation.

We explore the implications of the EU Action Plan in depth, delving into what this means at a practical level. We also examine what these megatrends and regulations mean for banks, pension funds, asset managers, insurance companies, central banks and other financial players.

We hope that you enjoy this report. If you want more information on how these developments impact you, our team would be delighted to help guide you on your sustainable finance journey.

JULIE CASTIAUX

Associate Partner, Head of Sustainable Services and Sustainable Finance

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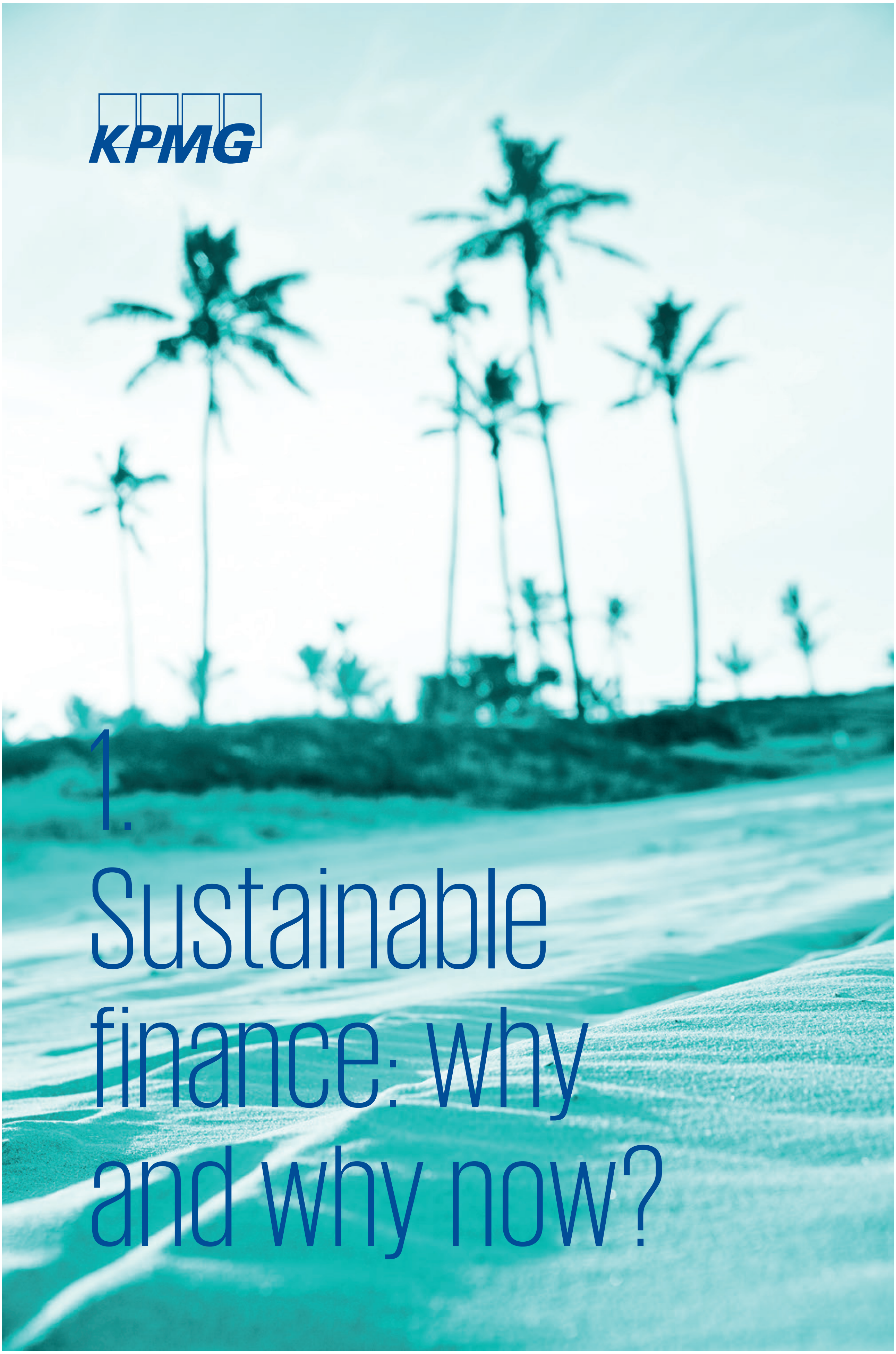


1. Sustainable finance: why and why now?

1.1 THE WORLD IS INCREASINGLY EXPOSED to environment-related risks

In 2019, according to the World Economic Forum's Global Risks Report, environmental risks accounted for three of the top five global risks by likelihood and by impact. It found that: "*Extreme weather was the risk of greatest concern with the results of climate inaction becoming increasingly clear*".

Back in 2012, Expect the unexpected, a report by KPMG Global, had already highlighted the fact that "*for 20 years or more we have recognized that the way we do business has serious impacts on the world around us*" and that it was "*increasingly clear that the state of the world around us affects the way we do business*".

This is a statement that has never been so true, and the sentiment expressed here is now shared by an increasing number of actors.

THE GLOBAL RISK OUTLOOK FOR 2019

	TOP 5 GLOBAL RISKS IN TERMS OF LIKELIHOOD	TOP 5 GLOBAL RISKS IN TERMS OF IMPACT
01	Extreme weather events	Weapons of mass destruction
02	Failure of climate change mitigation and adaptation	Failure of climate change mitigation and adaptation
03	Natural disasters	Extreme weather events
04	Data fraud or theft	Water crises
05	Cyber-attacks	Natural disasters

Environmental | Technological | Geopolitical | Societal

Source: World Economic Forum

1.2 BUSINESSES OPERATE IN AN INTERCONNECTED and globalized manner

Businesses today are operating in a more interconnected and globalized world than ever before. Supply chains stretch across continents and are vulnerable to disruption. Consumer demands and government policies are changing rapidly and will impact the bottom line of businesses. Against this background, the world faces a new set of global megatrends that translate into both challenges and opportunities that need to be assessed, mitigated and explored.

For 20 years or more, we have recognized that the way we do business and global conditions are closely correlated.

1.3 COUNTRIES AND PRIVATE PLAYERS COMMIT TO ambitious Sustainable Development Goals

On 1 January 2016, the 17 Sustainable Development Goals (SDGs) of the 2030 Agenda for Sustainable Development - adopted by world leaders in September 2015 - officially came into force. Countries and private players are being asked to mobilize efforts to contribute to these universal goals over the next fifteen years.

SUSTAINABLE DEVELOPMENT GOALS

1.4

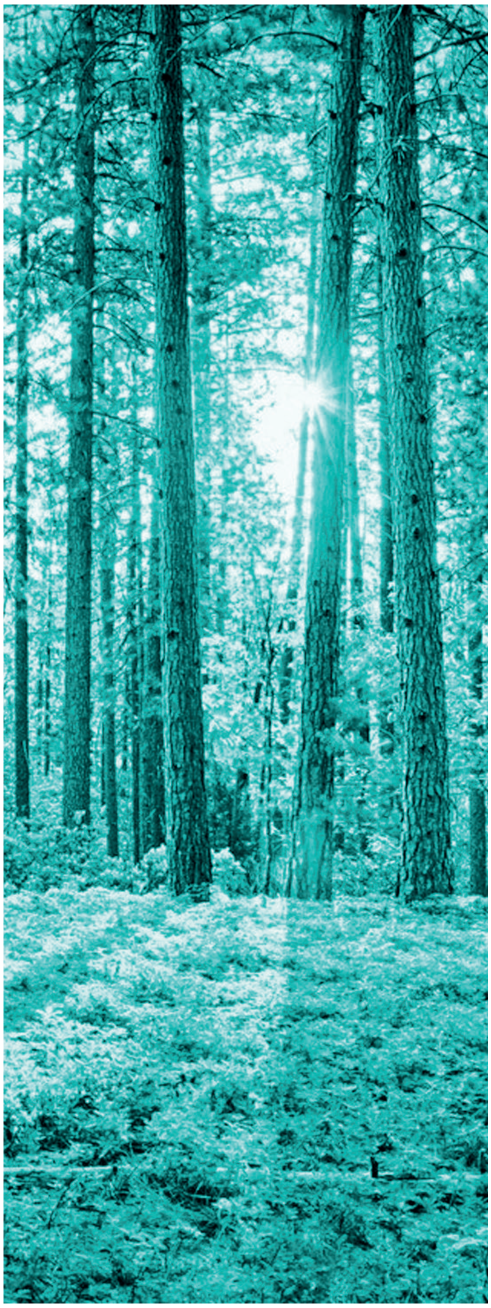
IN RESPONSE, SUSTAINABLE FINANCE EMERGES as the solution

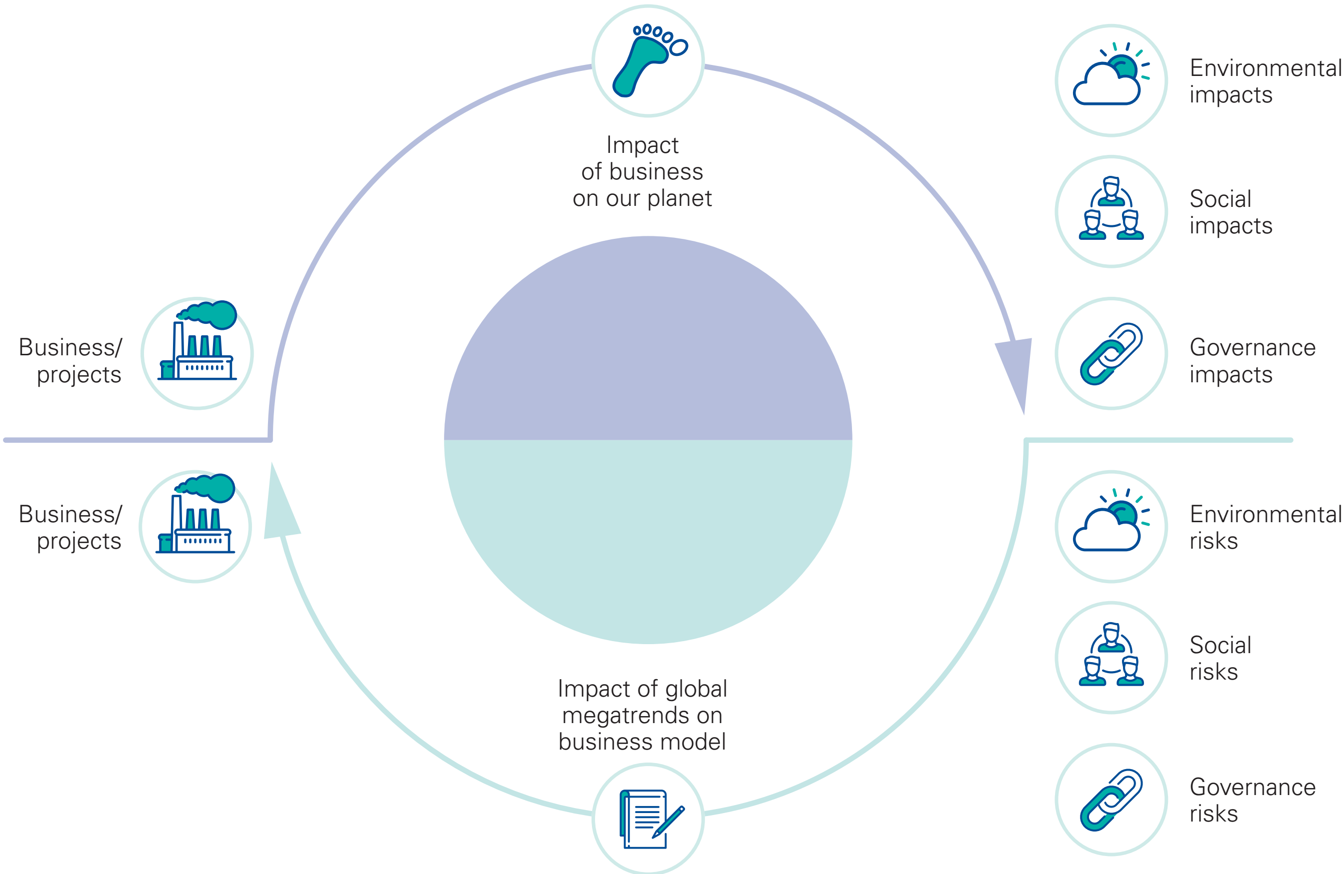
In response to some of the most pressing megatrends and environmental risks of our time - and with an understanding of the serious financial impacts that these can have - the financial sector is now stepping out of its passive role and is embracing the concept of sustainable finance in a more active and comprehensive way.

First, investors are starting to realize that sustainable finance fulfills a dual objective. First it aims to finance businesses or projects that can demonstrate a positive Environmental, Social and Governance (ESG) impact, thus enabling the transition to a low-carbon and more sustainable economy.

Second, by integrating ESG-related financial risks in their traditional risk management processes, investors are getting a more holistic view of how externalities, like climate change, could impact their portfolio and on that basis, they can take the necessary measures to address them.

As a result, sustainable finance is shifting away from being considered a niche investment product to being a new way of making investment and lending decisions.





Impact
of business
on our planet
Environmental
impacts
Social
impacts
Governance
impacts
Business/
projects
Business/
projects
Environmental
risks
Social
risks
Governance
risks
Impact of global
megatrends on
business model

Source: KPMG

Sustainable finance is shifting away from being considered as a niche investment product to being a new way of making investment and lending decisions.

1.5 THE SHIFT IS GLOBAL and the drivers for change are multiple

THESE TRENDS HAVE BEEN HIGHLIGHTED IN THE MEDIA

SUSTAINABILITY RISKS ARE ALREADY HAVING CONCRETE FINANCIAL IMPACTS

2019 16 JULY

Brazilian mining company to pay out £86m for disaster that killed almost 300 people.

theguardian.com

2019 22 JANUARY

After PG&E's Climate-Driven Bankruptcy, Who's Next?

bloomberg.com

2018 28 JULY

How Coca-Cola and Climate Change Created a Public Health Crisis in a Mexican Town.

ecowatch.com

ASSET MANAGERS INCREASE AND BROADEN THEIR ESG PRODUCT OFFER

UBS expands ESG offering with new equity and fixed income ETFs.

theguardian.com

2019 AUGUST

Nordea launches an ESG bond fund.

boursorama.com

2019 JULY

Fidelity International launches 'Sustainable Family of Funds' ESG range.

internationalinvestment.net

2019 15 MAY

2019 OCTOBER

Neumann Gruppe and BNP Paribas partner on sustainable sourcing farmers facility.

bnpparibas.com

2019 JULY

Sustainability-linked loans: giving firms incentives to improve.

bnpparibas.com

2019 JUNE

BNP Paribas Asset Management transforms active flagship range to become 100% sustainable.

bnpparibas.com

2018 OCTOBER

BlackRock takes sustainable investing mainstream with range of low-cost sustainable core ETFs.

blackrock.com

BANKS ARE SHIFTING THEIR PORTFOLIOS

2019
OCTOBER

ING will steer portfolio towards two-degree goal to help combat climate change.

ing.com

2019
SEPTEMBER

Natixis rolls out its Green Weighting Factor and becomes the first bank to actively manage its balance sheet's climate impact.

natixis.com

PENSION FUNDS MASSIVELY SHIFT THEIR MANDATES TO INCLUDE ESG

2019
16 SEPTEMBER

Government Pension Investment Fund (GPIF), the world's biggest pension fund, steps up passive stewardship efforts.

ft.com

2019
SEPTEMBER

Norway wealth fund gets green light for fossil fuel divestment. The world's largest sovereign fund has been given permission to ditch investments in fossil fuel.

eceee.org

2019
JUNE

ERAFP breaks new ground by publishing a measurement of its equity portfolio's alignment with the energy mix advocated in the "2°C" scenarios.

rafp.fr

2016
SEPTEMBER

To date, more than 370 investors with more than USD $35 trillion in assets under management have signed on to the Climate Action 100+ initiative. In September 2019, the initative released a Progress Report, that showed more investors are mobilizing across dozens of countries to drive corporate action on climate change (…) including a trebling in support for the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures.

climateaction100.org

STOCK EXCHANGES ARE CREATING GREEN SEGMENTS

The Nigerian stock exchange and the Luxembourg stock exchange sign MoU to expand the green bond markets.

bourse.lu

2019
OCTOBER

2019
OCTOBER

London stock exchange launches green economy mark and sustainable bond market.

iseg.com

2018
JUNE

The Luxembourg stock exchange (LuxSE) has launched a green bond channel in partnership with Shanghai stock exchange (SSE).

luxembourgforfinance.com

ESG RATING AGENCIES BEING ACQUIRED BY CREDIT RATING ONES

Morningstar buys 40% of ESG data firm Sustainalytics.

eceee.org

2018
JULY

2019
APRIL

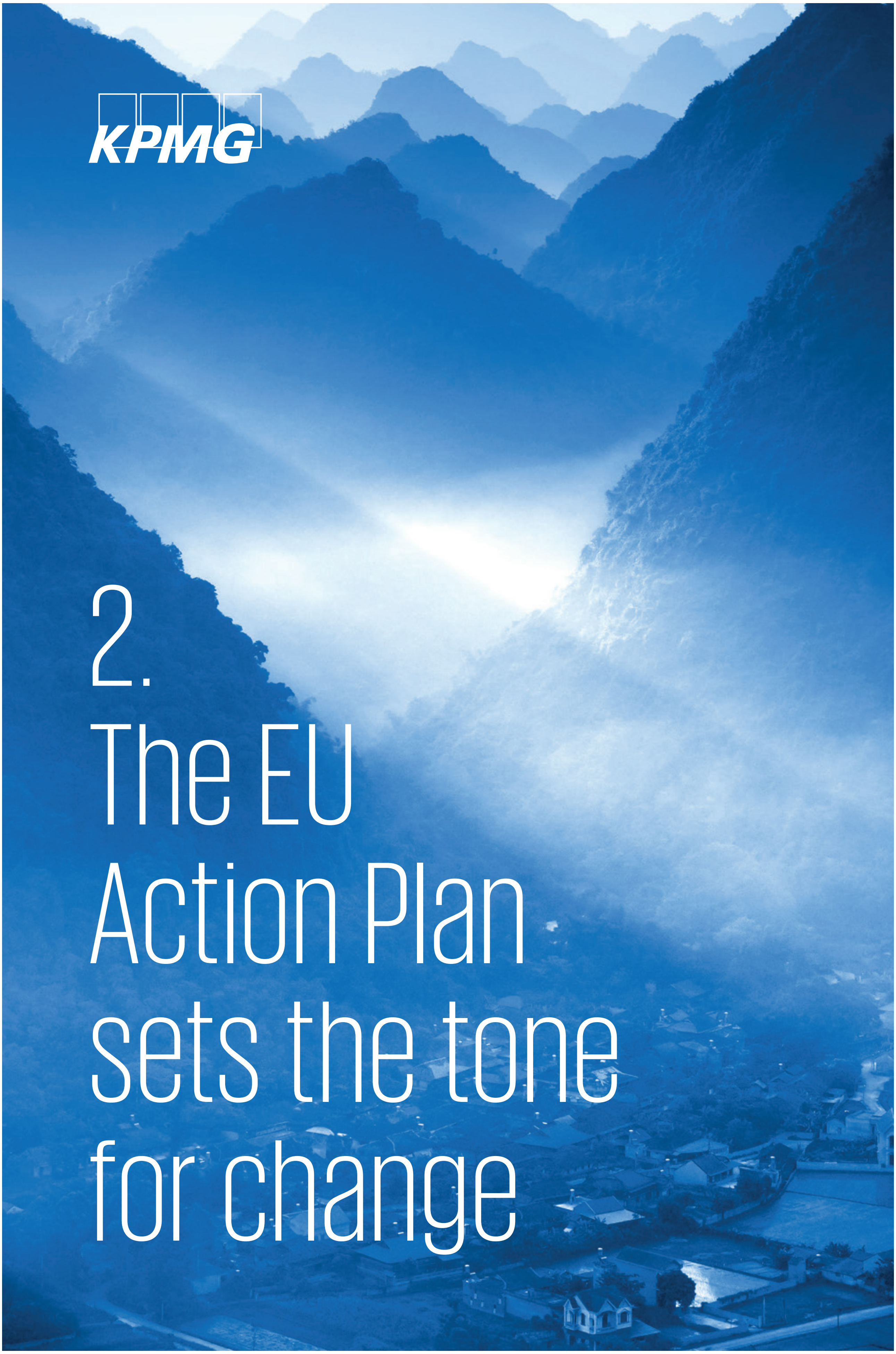
Moody's acquires majority stake in Vigeo Eiris, a global leader in ESG assessments.

moodys.com

2018
MARCH

Institutional Shareholder Services acquires oekom research for ESG ratings, data.

ipe.com



2. The EU Action Plan sets the tone for change

2.1 THE ACTION PLAN CLARIFIES THE ROLES and duties of financial players

As outlined previously, initiatives from the private sector have multiplied as investors attempt to seize new investing opportunities and better address ESG-related financial risks. Seeing these developments and wanting to give impetus for this movement, the European Commission (EC) decided to further clarify the roles and duties of financial players in the private sector, with their inclusion of ESG factors and risks in their investment decisions, risk management and reporting.

As a result, in March 2018, following the recommendations set in the final report of the High Level Expert Group on Sustainable Finance (HLEG), the EC unveiled Action Plan: Financing Sustainable Growth, setting out the EC's vision for the role of finance in sustainable development. The roadmap outlines concrete action points and proposes major regulatory changes to enable the transition to a low-carbon economy and a sustainable financial system.

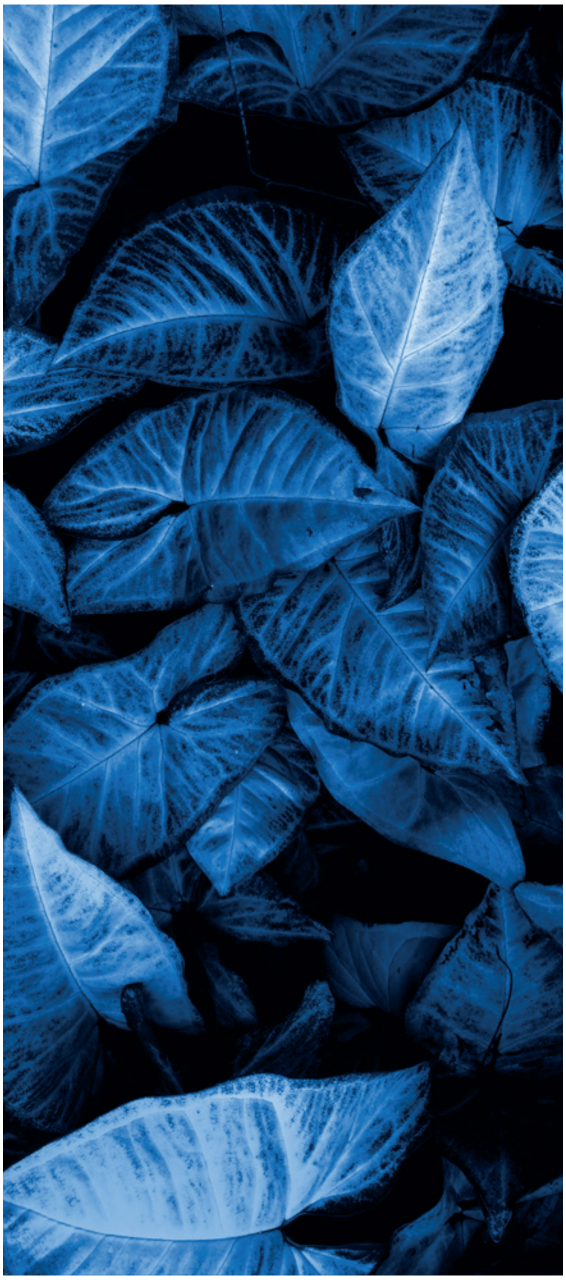
The action plan on sustainable finance adopted by the European Commission in March 2018 has 3 main objectives:

	REORIENT	capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth
	MANAGE	financial risks stemming from climate change, environmental degradation and social issues
	FOSTER	transparency and long-termism in financial and economic activity

2.2

THIS RESULTS in an ambitious legislative package

The Action Plan is overarching and results in new, as well as amended regulations, standards and guidelines, that aim to address the five major challenges listed on the next page. This legislative package will shake the entire financial industry, affecting all financial market players. Those who remain skeptical about the need to move to more sustainable finance will, in any case, have to make sure that they comply with the new regulations. And those who do not think that they need to abide by these rules because they do not sell sustainable investment products may have to face a harsh reality.



OVERVIEW OF THE TRANSLATION OF THE EU ACTION PLAN INTO A LEGISLATIVE PACKAGE

The EU Action Plan results in new regulations and amendments to existing regulations and directives that will most probably enter into force in the course of 2020 and become applicable from 12 to 18 months afterwards.

<table>
<tr><th></th><th>LACK OF DEFINITIONS</th><th>"RISK OF GREENWASHING"</th><th>UNDER CONSIDERED CLIMATE AND ENVIRONMENTAL RISKS</th><th>INVESTORS DUTIES</th><th>AVAILABILITY OF ESG DATA</th></tr>
<tr><td>CHALLENGES</td><td>No common definition of "sustainable investments", or "sustainable assets"</td><td>Risk of "greenwashing" of investment products</td><td>Banks, insurers and asset managers give insufficient consideration to climate and environmental risks</td><td>Investors disregard sustainability factors or underestimate their impacts</td><td>Too little information on corporate sustainability-related activities</td></tr>
<tr><td>ACTIONS</td><td>CLASSIFY SUSTAINABLE ACTIVITIES</td><td>CREATE STANDARDS AND LABELS FOR "GREEN" FINANCIAL PRODUCTS</td><td>ENHANCE CONSIDERATION OF SUSTAINABILITY RISKS IN INVESTMENT DECISION-MAKING AND CAPITAL REQUIREMENTS</td><td>CLARIFY INSTITUTIONAL INVESTORS DUTIES TO CONSIDER SUSTAINABLE FINANCE WHEN ALLOCATING ASSETS</td><td>ENHANCE NON-FINANCIAL INFORMATION DISCLOSURE</td></tr>
<tr><td rowspan="3">LEGISLATIVE IMPACTS</td><td rowspan="3">Proposal for a regulation on the establishment of a framework to facilitate sustainable investment (Taxonomy regulation)</td><td>EU Green Bond Standard</td><td>Amendment to the Solvency II Directive Amendment to the Capital Requirements Directive/ Regulation (CRR/CRD)</td><td>Amendment to the Market in Financial Instruments Directive (MiFID II)</td><td>Non-binding guidelines on reporting climate-related information</td></tr>
<tr><td>EU Ecolabel for financial products</td><td>Amendment to the Undertaking for Collective Investment in Transferable Securities (UCITS)</td><td>Amendment to the Insurance Distribution Directive (IDD)</td><td>Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending the Institutions for Occupational Retirement Provision Directive</td></tr>
<tr><td>EU Climate Benchmarks and benchmark ESG disclosures: amendment to EU benchmark regulation</td><td>Amendment to the Alternative Investment Fund Managers Directive (AIFMD)</td><td>Shareholders right directive</td><td>Credit rating agencies</td></tr>
</table>

Source: KPMG

Financial market players who remain skeptical about the need to move to a more sustainable finance model will, in any case, have to make sure that they comply with the new regulations. And those who do not think they are covered by these rules because they do not sell sustainable products may have to face a harsh reality.

3. Compelling financial market players to take action

The EU Action Plan is very broad in reach and has taken up the challenge of connecting the dots between all the regulations that financial market players are subject to, in order to produce a clear and cohesive global regulatory picture. As a result, banks, insurance companies, asset managers, pension funds, investment advisers, credit rating and sustainability rating agencies, investment consultants, stock exchanges and financial centers, all have a role to play. **These financial market players will therefore need to focus considerable effort on anticipating the opportunities and market differentiators that this new wave of regulation will bring and how best they can capitalize on the coming changes.**

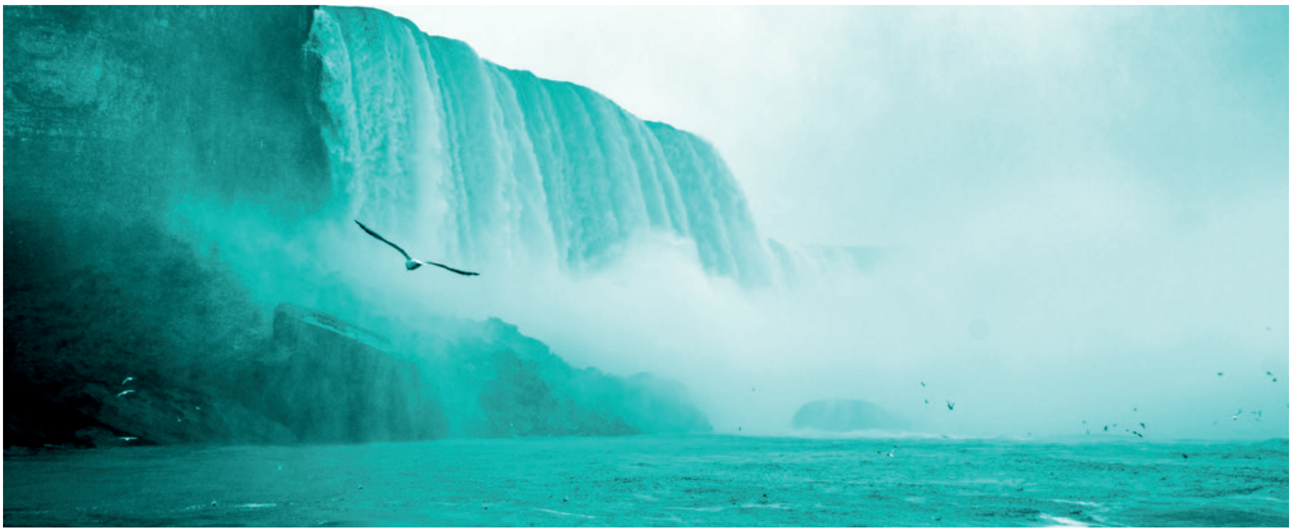
3.1 PENSION FUNDS

Pension funds, as large asset owners on top of the investment chain, set the demand for ESG incorporation into investment decision-making. Through mandate setting, they ensure that their investment beliefs and commitments are reflected in their strategies, in their governance processes and in the contractual relationships they have with their investment managers. Given their long-term investment horizon, they are also required to focus on managing ESG risks, notably those related to climate change.

On 22 October 2019, the International Organisation of Pension Supervisors (IOPS) published Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds.

THESE GUIDELINES PROPOSE THAT PENSION SUPERVISORY AUTHORITIES SHOULD:

- clarify to a pension fund governing body or the asset managers that the explicit integration of ESG factors into pension fund investment and risk management process is in line with their fiduciary duties;
- require that a governing body and the asset managers involved in the development and implementation of the pension fund's investment policy, integrate ESG factors, along with all substantial financial factors, into their investment strategies;
- require that a governing body or the asset managers involved in the development and implementation of the pension fund's investment policy will report to supervisory authorities on how they integrate ESG factors in their investment and risk management process;
- require that a governing body or the asset managers of a pension fund disclose information to members and stakeholders about the pension fund's investment policies;
- require that pension funds regularly provide reports on their engagement with investees as well as request companies in which they invest to disclose their ESG-related policies, and encourage a governing body or the asset managers of a pension fund to develop appropriate scenario testing of its investment strategy.



3.2

INSURANCE COMPANIES as the solution

Insurance companies, as the largest institutional investor group in Europe - and operating with very long investment horizons - have a major role to play in the financing of the transition to a low-carbon economy. As risk managers, they also play a central role in the identification and measurement of material climate risks.

They can make a difference by integrating ESG factors and risks into both the assets and the liabilities sides of their balance sheets.

In February 2019, in order to provide a support tool to the industry, UNEP FI's Principles for Sustainable Insurance (PSI) initiative published the first ESG guide for the global insurance industry highlighting the *"growing interest in the insurance industry and the wider financial sector in understanding the correlation between ESG factors and strong performance of companies across industries".*
A full version will be published in December 2019 following public consultation and feedback and is intended to be updated annually thereafter.

LIFE INSURANCE

THE PREFERRED INVESTMENT OF FRENCH PEOPLE SHOULD IMPROVE THE FINANCING OF THE ECOLOGICAL AND SOLIDARITY TRANSITION

After a flurry of amendments, by 2022, each product of this type in unit of account (UC) must offer its subscribers at least one UC corresponding to a socially responsible investment (SRI label), or one intended to finance the energy transition (TEEC label) or another stamped "*solidarity finance*" (which can be tagged as "*Finansol label*").
Banks and insurers will also have to better inform their subscribers on the real share of their savings allocated to ecological transition or the solidarity sector, as well as on contract yields.

Source: Novethic: La loi Pacte veut pousser l'assurance-vie à financier la transition énergétique, Avril 2019

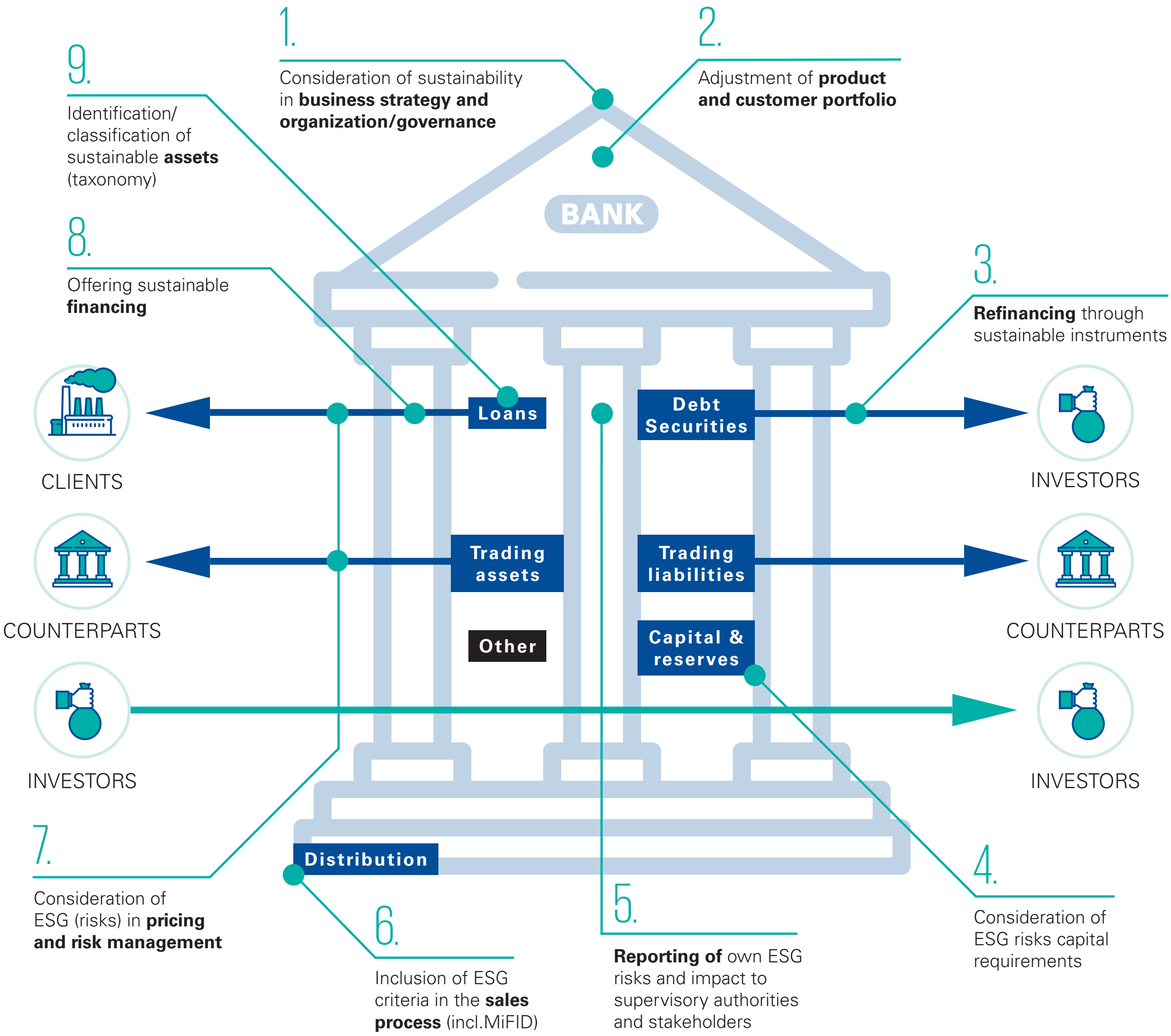
Climate change is having significant effects on our economies, our communities and our lives.
In 2018, nearly 900 natural disasters were recorded, leading to overall losses of around USD 180 billion. Only 45% of these losses were insured. The majority of losses were covered by private households, enterprises or public authorities.

Source: Cf. Munich Re NatCatSERVICE.

3.3 BANKS

As the largest source of external financing in the EU, banks are an essential component of the financial system. As such, the lending and financing activities must form part of the transition to a low-carbon economy. "*As the backbone of the European financial system, they also have a responsibility*" to strengthen the financial system's stability by better managing their exposure to material ESG risks.

ESG IN DISCLOSURES	In the future, banks will have to enhance their disclosures with regards to climate-related financial risks, but also with regards to the financial products that they offer to their investors.
ESG IN RISK MANAGEMENT PROCESSES	Banks may also need to reflect on how to integrate ESG risks into the Pillar 2 supervisory review processes, Internal Capital Adequacy Assessment Process (ICAAP) and Supervisory Review and Evaluation Process (SREP), as it is likely that supervisory authorities will take a closer look at the integration of ESG risks by their supervised entities in the years to come.
ESG IN BUSINESS STRATEGIES AND INVESTMENT STRATEGIES	Banks will need to reflect on how to further integrate ESG factors into, and foster longtermism in their lending and investment activities in response to sustainable funding needs - using, for example, financial instruments such as green loans, green bonds, green securitization, etc.



Source: KPMG Germany

3.4 ASSET MANAGERS

In investing their clients' money, asset managers (AMs) have a duty to act in the best interests of these investors. This means, on the one hand, that AMs should ensure they are equipped to address the preferences of their clients - including their sustainability preferences - and, on the other hand, that they should be fully transparent regarding the products they offer and the ESG impacts of those products. In addition, in their equity and debt financing activities, AMs that invest in listed or private equity should integrate ESG considerations throughout their investment value chain, from product manufacture right through to disclosure to investors.

TO MEET THE NEEDS OF INVESTORS	▪ AMs will have to identify the sustainability preferences of their clients
TO MANUFACTURE NEW PRODUCTS	▪ AMs may want to design their products in line with the upcoming EU taxonomy and with specific ESG criteria in mind
TO INVEST IN A SUSTAINABLE WAY	▪ AMs will need to integrate ESG factors and risks into their due diligence and investment decision-making processes, as well as their monitoring activities
TO MEASURE THE IMPACT	▪ AMs will have to demonstrate the impact of their investment product portfolio[s], specifically in terms of carbon emissions and contributions representing progress toward the UN SDGs
TO MARKET EFFICIENTLY	▪ AMs may want to market their products using sustainability labels or certifications that are recognized on the market
TO DISCLOSE TRANSPARENTLY	▪ AMs will have to disclose, in various required documents, how they take sustainability risks into consideration in their investment decisions and how their "sustainable investment" products meet their objectives

Source: KPMG

KPMG's Global CEO Outlook 2019 found that, for asset management CEOs, environmental/climate change risk has now become the number one threat to business growth - thus demonstrating the rising importance and recognition of environmental issues.

Specifically, 68% of CEOs in the asset management industry agreed that organizational growth will be determined by their ability to anticipate and navigate the global shift to a low-carbon, clean technology economy.

GREATEST THREATS TO GROWTH IN DESCENDING ORDER

2019	2018
ENVIRONMENTAL/ CLIMATE CHANGE RISK	RETURN TO TERRITORIALISM
EMERGING/ DISRUPTIVE TECHNOLOGY RISK	ENVIRONMENTAL/ CLIMATE CHANGE RISK
RETURN TO TERRITORIALISM	EMERGING/ DISRUPTIVE TECHNOLOGY RISK
OPERATIONAL RISK	OPERATIONAL RISK
CYBER SECURITY RISK	REPUTATIONAL RISK

Source: 2019 Global CEO Outlook - asset management data, KPMG International

3.5 CENTRAL BANKS and financial supervisors

The legal mandates of central banks and financial supervisors typically include responsibility for price stability, financial stability and the safety and soundness of financial institutions. Following COP21, however, it became obvious that central banks had a role to play - in cooperation with the financial sector, policy makers, academia and other stakeholders - to instill best practices in addressing climate-related risks.

In order to better understand and manage the financial risks and opportunities stemming from climate change, a grouping of central banks and supervisors - the Network for Greening the Financial System (NGFS) - was created in December 2017. Since then, its members have participated in different workstreams such as supervision, macro-financial and mainstreaming green finance. The NGFS published its first comprehensive report in April 2019, followed by a technical supplement in July 2019.

THE 6 RECOMMANDATIONS OF THE NGFS

1. Integrating climate-related risks into financial stability monitoring and micro-supervision
2. Integrating sustainability factors into own-portfolio management
3. Bridging the data gaps
4. Building awareness and intellectual capacity and encouraging technical assistance and knowledge sharing
5. Achieving robust and internationally consistent climate and environment-related disclosure
6. Supporting the development of a taxonomy of economic activities

Recommendations n°5 and 6 do not fall directly within the remit of central banks and supervisors but point to actions that can be taken by policymakers to facilitate the work of central banks and supervisors. Parts of these recommendations may also be applicable to the private sector.

Climate-related risks are a source of financial risk. It is therefore within the mandates of central banks and supervisors to ensure the financial system is resilient to these risks.

NGFS First Comprehensive Report, April 2019.

3.6 STOCK EXCHANGES

Finally, stock exchanges are uniquely positioned to foster money flows towards sustainable products or companies, enhance disclosure and transparency and strengthen resilience of capital markets to the potential economic impact of climate change.

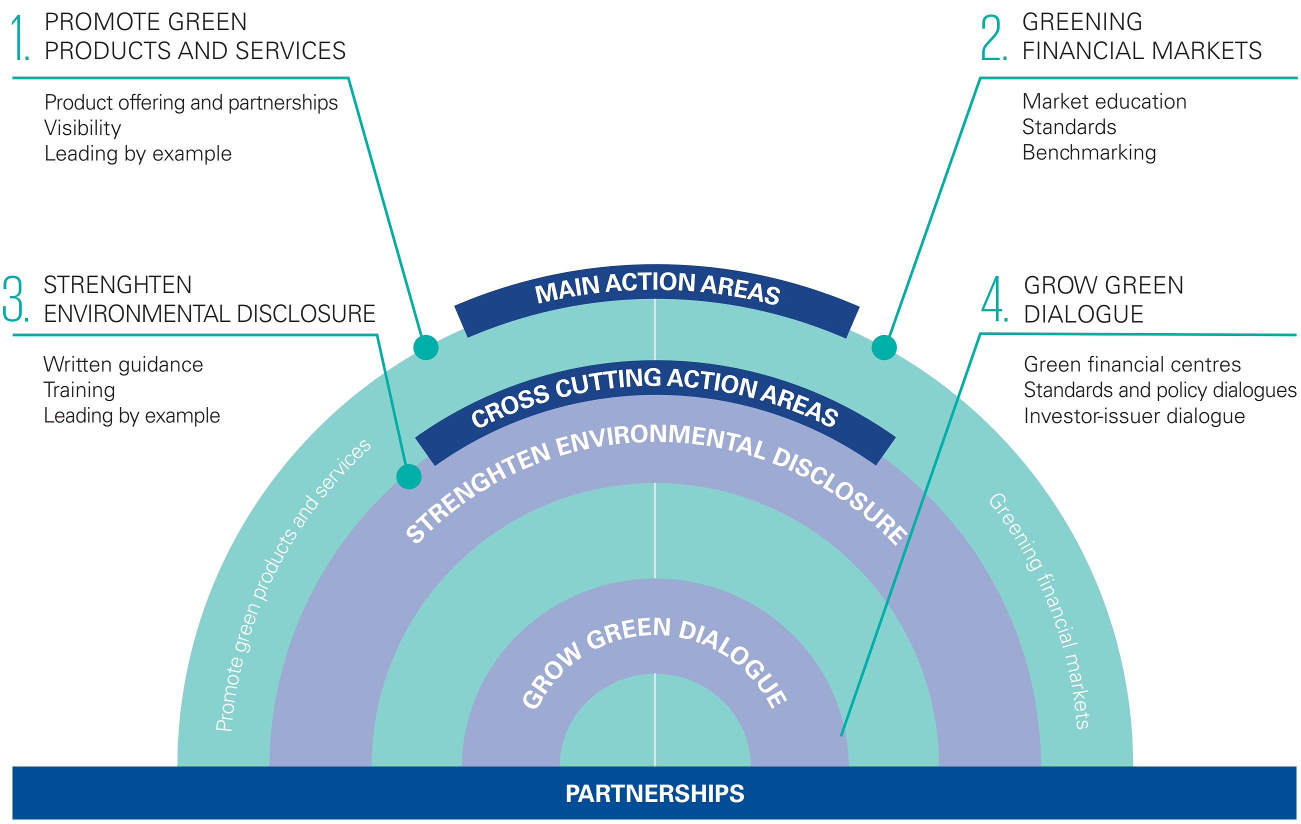
Since 2009, the Sustainable Stock Exchanges (SSE) initiative has been working with stock exchanges to encourage partnerships and the adoption of best practices in the area of responsible investment for sustainable development. The SSE published a number of reports, amongst which was a voluntary Action Plan on "*how Stock Exchange can grow green finance*" in 2017. This Action Plan identifies two main action areas that stock exchanges should work on in parallel:

- First, the promotion of green-labelled products and services helps direct funding towards green projects and environmentally aligned issuers. This is, for example, the case with green bonds, green indices, green Real Estate Investment Trusts (REITs);

- Secondly, more systematic and holistic changes must take place to support a green transition and ensure market resilience to the economic impacts of climate change.

In 2018, the World Federation of Exchanges (WFE) issued a set of five WFE Sustainability Principles that constitute a formal declaration by the WFE and its membership to take on a leadership role in promoting the sustainable finance agenda.

A GREEN FINANCE ACTION PLAN FOR STOCK EXCHANGES



Source: Sustainable Stock Exchanges, How stock exchanges can grow green finance

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