The Depth & Breadth of Sustainable Finance Regulatory Initiatives: Global Developments in 2022

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Key Takeaways

- The scope and pace of global sustainable finance regulation has accelerated in 2022 across an array of regulatory areas (taxonomies, ESG and climate risk management and disclosures, product requirements, ESG in stewardship, and green bond frameworks).
- Regulatory efforts continue to prioritize management of climate-related financial risk as well as preventing greenwashing, although the agenda is beginning to expand to nature-related risks and social issues as well.
- The European Union continues to be the leading region in the depth and breadth of its regulatory initiatives.
- Asia has accelerated the pace of growth in new initiatives, and North America and Australia have significantly increased their regulatory efforts for ESG-related capital markets. The UK has also proposed and is expected to advance an ambitious agenda.
- In 2022, geopolitical tensions, economic volatility, and the politicization of sustainable finance have created policy challenges. Given these conditions, policymakers may aim to pursue sustainable finance regulation that reconciles policy objectives and fosters economic and energy resilience in line with climate transition goals.

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Introduction

As forecast in the inaugural edition of this report series, the scope and pace of sustainable finance regulation has accelerated in 2022 across all capital markets, increasing the regulatory momentum of years past and building on market practices. All regions see sustainable finance regulation as critical to increasing market transparency and reducing risks of greenwashing (that is, intentionally or unintentionally marketing investment products as more green or sustainable than they are). Some regions also apply Environmental, Social, and Governance (ESG)-related capital markets regulation to support the development of a sustainable investment market that contributes to the transition to a low-carbon economy. Sustainable finance regulation has helped to define sustainable investment activities and investment product categories and to enhance consistent disclosure of how companies and investors are managing ESG risks and opportunities.

Policymakers have also had to consider the goals of sustainable finance regulation against the political realities of economic and geopolitical volatility in 2022. The debate in the European Union about whether nuclear energy and natural gas have a place in green taxonomies is a prominent example of the clash between political and sustainable finance objectives, and of how the politicization of sustainable finance frameworks can create a perceived conflict with broader political and economic national interests. The materiality of ESG factors and the goals of sustainable investment are being debated globally and are under heavy scrutiny.

Comprehensive, comparable, and high-quality ESG data enables investors to implement sustainable investment strategies, assess taxonomy alignment, and manage ESG risk and impacts as well as their own disclosure requirements. Although corporate sustainability reporting standards such as the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), and the Task Force on Climate-Related Financial Disclosures (TCFD) have helped companies with their disclosures by providing a voluntary reporting framework, regulators have more recently started introducing mandatory corporate reporting.

The year 2022 has been a watershed for regulation mandating climate and ESG reporting by corporate issuers across major capital markets. Jurisdictions such as the EU, the US, New Zealand, Japan, India, China, the Philippines, Taiwan, Chile, and Switzerland have or are developing relevant rules or guidelines. In addition, the International Sustainability Standards Board (ISSB) published its exposure drafts for global ESG standards. This report has a specific focus on regulatory initiatives aimed at the financial market, however.

ISS ESG continues to monitor the development of sustainable finance regulation and has updated key regulatory themes and trends against those identified in our 2021 report. Key among these:

- Taxonomies
- Climate risk management and disclosure
- ESG risk management and disclosure
- Product standards, disclosures and labelling
- ESG in stewardship/engagement
- Green bond guidelines

ISS ESG has developed a proprietary 'regulation depth and breadth index' to evaluate the maturity of a country's sustainable finance regulation, measured by both the number of relevant regulatory initiatives as well as the range of regulatory topics addressed. The index compares regulatory developments across countries and regions and captures the evolution of regulation across the identified regulatory themes in 2022 relative to 2021, when the index was launched.

Sustainable Finance Regulatory Topics

Taxonomies

Taxonomies for sustainable finance are a classification tool to define boundaries and underlying principles and criteria for economic activities considered 'green' or environmentally sustainable. Regulators are increasingly using taxonomies to try to underpin clear and consistent definitions for 'green' financial instruments within an ever-evolving market.

Moreover, by creating national taxonomies that align with internationally agreed principles, governments can promote progress towards internationally agreed goals regarding climate protection and sustainable development, as well as maintain a regulatory framework to mitigate greenwashing. Consistent information about green instruments can be used to incentivize ambitious climate goals.

Taxonomies usually define what constitutes a contribution to achieving environmental objectives such as climate change mitigation and the transition to a low-carbon economy. Taxonomies are often used to verify the eligibility of green bonds or other green financial instruments such as loans and funds. They might also be applied as a voluntary classification tool or as part of the mandatory disclosure requirements for investment exposures.

More than 20 countries or regions around the world have developed or are currently developing sustainable or green taxonomies. Regulators have continued the trend of developing sustainable finance taxonomies by combining international frameworks with national laws and circumstances.

The South African Treasury, for example, recently published its final green taxonomy, which is to be formalized by the end of 2023. The taxonomy aims to introduce national context, such as regarding a just transition, to international best practices. It has a strong overlap with the EU taxonomy.

Sri Lanka's central bank has worked with the International Finance Corporation to launch the country's Green Finance Taxonomy. This is the first national taxonomy that takes into consideration the Common Ground Taxonomy created by the International Platform on Sustainable Finance.

While different national taxonomies are often developed using common frameworks, they can take divergent approaches in terms of granularity and prescriptiveness. Some taxonomies have taken principle-based approaches, while other taxonomies — such as the EU taxonomy and the Indonesian green taxonomy launched in January 2022 — take more granular approaches. The Indonesian taxonomy categorizes hundreds of subsectors and business activities using a 'traffic light' system to facilitate capital flows into the green economy and provide a guideline for policy incentives.

Some regulatory bodies have attempted to delve into social goals in their taxonomies. Mongolia's taxonomy explicitly promotes the goal of livelihood improvement. Colombia recently became the first country in Latin America to release a national taxonomy framework. While it essentially defines economic activities that contribute to climate change mitigation and adaptation as well as other environmental objectives, the taxonomy also includes a new emphasis on land use, thus adding a social element to the framework. In the EU, the European Commission's expert advisory group, the Platform on Sustainable Finance, released a report in February 2022 with a proposal for a social taxonomy. This proposal has not yet been taken up by the Commission, however.

Climate Risk Management and Disclosure

As the global emphasis on sustainable finance has grown, institutional investors increasingly view climate risk as material, and thus view climate risk management as part of their fiduciary duty. Regulators have sought strategies to ensure that financial institutions are understanding, disclosing, and mitigating the climate risk of their financing and investment. National regulators consequently often use international voluntary frameworks such as the Task Force for Climate-related Financial Disclosures (TCFD) to mandate climate disclosures by financial market participants. They may also issue supervisory guidance to encourage or require climate risk management by financial entities, especially in Asian countries.

Central banks (for example, in the European Union, the United States, Taiwan, Canada, Japan, and Malaysia) have launched or are considering applying stress tests and climate scenario analysis to assess banks' climate change risk exposure. Moreover, several central banks (for example, in Peru, Brazil, Mexico, Chile, Colombia, the United States, and Canada) are considering incorporating climate-related risks into their reserve management frameworks. Central banks and other prudential regulators are also increasingly integrating climate risk into their day-to-day supervisory activities. Institutions in this last category include the European Central Bank and the Bank of England.

Regulators are also starting to require or encourage the development and disclosure of climate transition plans. Transition plans outline how an entity intends to ensure its operations and business model align with the latest science-based climate recommendations, such as reaching Net Zero by 2050. These plans can include targets and actionable steps.

The UK's Transition Plan Taskforce (TPT) issued a proposal for mandatory disclosure of transition plans by financial institutions and listed companies. The UK Financial Conduct Authority (FCA) will draw on the outputs of TPT's work to "strengthen disclosure rules for listed companies and financial firms."

Management and disclosure obligations regarding climate risk continue to differ in their understanding of materiality. One approach emphasizes financial materiality or enterprise value, focusing on the climate risks that an entity is exposed to and how climate change might impact the entity's financial performance. Alternatively, regulators can apply a double materiality approach, also referred to as stakeholder materiality or dynamic materiality. This approach considers not only the risk of climate change to a company but also the impact an entity has on climate change through its operations and value chain. The European Union has championed the latter approach, while the ISSB has prominently adopted the financial materiality approach.

ESG Risk Management and Disclosure

Risk management and disclosure requirements can extend to the broader range of ESG issues beyond climate change. In addition to voluntary codes on ESG consideration, regulators may require consideration of ESG risks. They tend to approach the issue with differing perspectives regarding financial market participants, the approach to materiality, and enforcement, however.

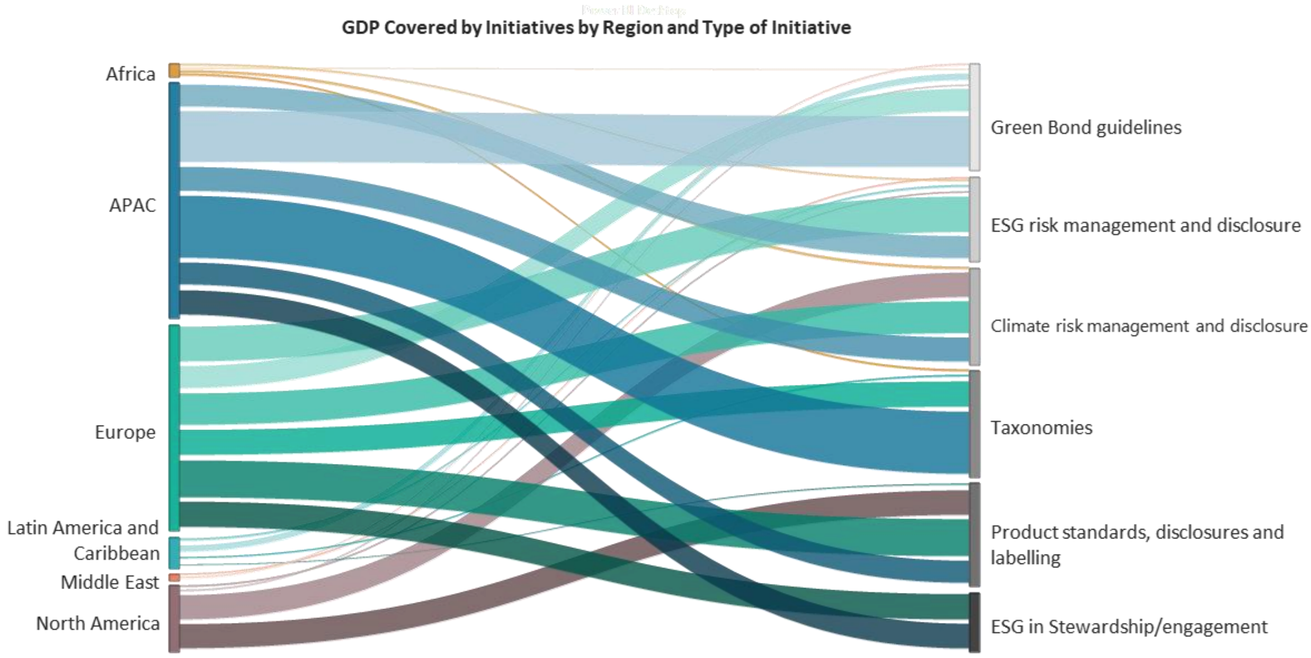
The most comprehensive regulation of this kind remains the EU's Sustainable Finance Disclosure Regulation (SFDR). This regulation includes templates for disclosure of pre-defined ESG factors and requires financial market participants to explain how they consider ESG risks and impacts in their investments.

The UK is developing regulation similar to the EU's SFDR, known as the Sustainability Disclosure Requirements (SDR). The SDR will likely entail consumer-facing product disclosures aimed at retail investors that cover sustainability objectives, strategy and metrics, the proportion of assets aligned with the UK Taxonomy, and the approach to investor stewardship. More detailed product-level and entity-level disclosures aimed at institutional investors would be required, including information on how risks and opportunities are incorporated into the investment process at the entity level. Elements of the UK and EU regulations are compared and contrasted in ISS ESG's recent New Horizons 2022 report, in the EMEA edition.

National regulators and supervisors are approaching ESG risk management through efforts that target different market participants. Following the SFDR's focus on disclosing financial institutions' investments, the EU has continued expanding the scope of its ESG-related regulation by releasing a framework for banks to disclose qualitative ESG risk. The Nepalese Central Bank also updated its environmental and social risk management framework by expanding the ESG disclosure checklist banks and financial institutions must complete for any transaction.

Other countries, including Vietnam, Bangladesh, and Brazil, have already implemented efforts to address ESG risk management and disclosure in lending. Similarly, provisions on ESG disclosure requirements for pension funds exist or are being developed in markets as varied as Canada, the UK, South Africa, Colombia, and Peru. On the benchmark side, the EU's Benchmark Regulation mandates comprehensive ESG disclosures for all types of benchmarks (with certain exceptions).

Figure 1: A myriad of regulation in all shapes and sizes
(GDP covered by initiatives within each region, by regulatory topic, in 2022)



Source: ISS ESG Research

Product Standards, Disclosures, and Labelling

The legitimacy of a sustainable investment is difficult for retail investors to discern without access to transparent information on the investment methodology of ESG-labeled funds. As ESG-themed investment grows more popular, regulators perceive an increasing risk of greenwashing. Consequently, new anti-greenwashing rules and guidance can be observed across the globe, from Canada to New Zealand. These rules identify what providers of sustainable investment products must disclose and how they should present sustainability-related claims about their products and due diligence processes.

Supervisors are stepping up their product and investment process reviews for investor protection, looking more closely at ensuring that ESG products are true to their name and that fund managers can substantiate their ESG claims. The regulatory levers used vary from supervisory guidelines to binding regulation and from disclosure requirements to minimum thresholds, as well as enforcement initiatives.

The Association of Southeast Asian Nations (ASEAN) is developing its supervisory Sustainable and Responsible Fund Standards. The standards, while not legally binding, would create a common supervisory basis for Asian regulators to create disclosure and reporting requirements for investment funds on sustainable and responsible investment (SRI) objectives and strategies.

Individual national regulators are following up with binding approaches. In a July 2022 circular, the Monetary Authority of Singapore (MAS) identified expectations for how existing requirements apply to retail ESG funds, as well as the disclosure and reporting guidelines applicable to such funds regarding fund naming, prospectus disclosure (on, for example, objectives, strategy, and processes), and periodic reporting.

The Philippines' SEC has issued new draft rules for sustainable and responsible investment funds that require these funds to adopt one or more sustainability principles or considerations of ESG factors as their key investment focus, and adequately reflect this in their investment objectives and strategy. SRI funds must also have at least 70% of their net asset value allotted to ESG investments. The draft rules specify which nationally or globally accepted ESG principles or criteria SRI funds may consider, such as the UN's Sustainable Development Goals (SDGs) or Global Compact Principles. They also set out the strategies such funds may adopt to achieve their investment objectives, such as negative screening or impact investing.

The EU's SFDR had already created product categories and corresponding disclosure requirements to increase transparency in sustainable finance products. SFDR requires sustainable investment products to self-classify as 'Article 8' or 'Article 9' products under the regulation. The changes to the EU directives MiFID (Markets in Financial Instruments Directive) and IDD (Insurance Distribution Directive), which came into effect in August 2022, build on the SFDR by prescribing the three types of products that can be offered to clients that voice sustainability preferences during mandatory suitability assessments when they receive financial advice. As regulators in Europe have grown concerned over perceived greenwashing issues that have arisen from self-classification, the European Commission plans to propose minimum sustainability standards for Article 8 funds.

Hong Kong's ESG fund disclosure requirements, which are similar to SFDR Article 8 product disclosures, came into effect in January 2022. Disclosure requirements include funds' ESG strategies, methodology, and criteria, as well as asset allocation, sources used, estimations, due diligence, and engagement activities undertaken. These rules are more principle-based than SFDR, however. In the UK and the US, regulators are also working on fund disclosures, name rules, and labelling/classification systems.

ESG in Stewardship/Engagement

ESG has become increasingly relevant within the realm of corporate governance. Stewardship and shareholder engagement allow for communication between boards and investors and can motivate positive change within companies. Stewardship and engagement activities vary from dialogue between companies and investors to the introduction of shareholder resolutions and shareholder voting during annual general meetings (AGMs). Some regulators have emphasized ESG factors as a component of stewardship and stewardship as a component of responsible investment.

The EU has taken regulatory action to mandate stewardship as an essential aspect of shareholder rights. In the Shareholder Rights Directive (SDR II), the EU created a broad framework for mandatory stewardship, but without delving into specific ESG issues to be addressed. Partially filling this gap, the SFDR requires the disclosure of engagement activities related to a set of adverse impact indicators. Financial market participants also need to explain how they follow up when investee companies do not take sufficient action to reduce adverse impacts.

The UK had already updated its Stewardship Code in 2020 to require disclosure of engagement and voting regarding sustainability issues based on outcomes. Outside of Europe (in Singapore, India, Japan, and Russia, for example), stewardship codes have been updated to include ESG topics and require or recommend active engagement on ESG factors. This can involve using checklists or guidelines with topics to engage on or questions to ask investee companies. Moreover, the Japanese FSA has made it clear that asset managers with ESG funds should proactively conduct stewardship activities.

Green Bond Guidelines

Green bonds are some of the most developed and regulated financial instruments in the world of sustainable investing. Regulators, supervisors, and stock exchanges utilize green bond guidelines to regulate this fast-growing market. Such frameworks outline the eligible objectives/activities to be financed, while requiring disclosures to ensure that the proceeds are used correctly. They are often linked to a taxonomy or eligible project list and might require verification or certification by independent external reviewers.

While most bond standards focus on 'green' topics, some jurisdictions, including African and South American markets, have standards that cover broader ESG goals. Chile, Argentina, Morocco, and Senegal are among the nations that apply guidelines for social or sustainability bonds. The EU and ASEAN have both developed regional green or sustainable bond standards. The desire to raise, and properly allocate, investments through green bonds has also led many Asian nations to develop national green or sustainability bond frameworks. Singapore, for example, has published its own Green Bond Framework. In the Philippines, the Bureau of the Treasury established a Sustainable Finance Framework for green, social, or sustainability bonds, loans, and other debt instruments.

Extending green bond standards to cover lending activities or other types of financing is a wider trend. Malaysia, a market active in Islamic finance, has developed an SRI Sukuk Framework, issued by the country's Securities Commission (SC). Some jurisdictions offer incentives for green or sustainable bonds. As part of the grant and tax incentive schemes in Malaysia, for example, tax deductions are available both for the issuance expenditure of green, social, or sustainable bonds and sukuk approved by the Malaysian SC (until 2023), and for up to 90% of the costs of external verifier reviews of sukuk issuances under the Malaysian SRI Sukuk Framework. This incentive is also available to bond issuances under the ASEAN Green, Social, and Sustainability Bond Standards.

Sustainability-linked bonds are a relatively new sustainable finance instrument. These are used for financing an issuer's strategy to achieve predefined sustainability objectives within a set timeline. The issuer must commit to Sustainability Performance Targets (SPTs) around pre-determined KPIs. To provide guidelines on structuring features, disclosure, and reporting, ICMA developed the Sustainability-Linked Bond Principles. The International Financial Services Centres Authority (IFSCA) — a key regulator for Indian financial markets — drafted sustainability-linked guidance for financial service centers' lending practices. In line with the recent growth in sustainability-linked bonds, Malaysia in July 2022 launched an SRI-linked sukuk framework, allowing issuers to secure financing at preferential rates if they achieve a set of sustainability KPIs.

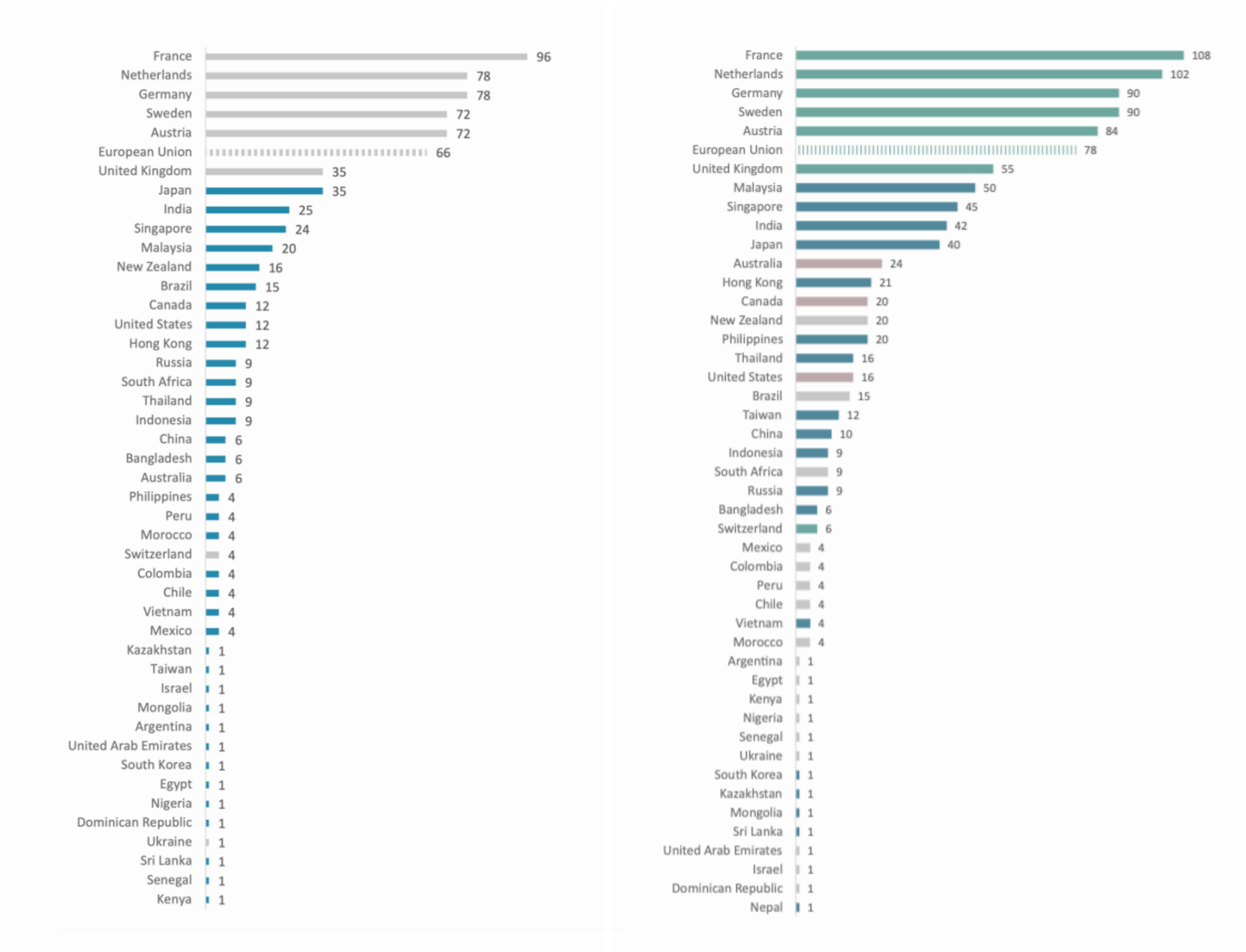
Another growing trend is green securitization, meaning the securitization of green financial assets. Either the collateral on the loans are green assets (for example, asset-backed securities such as electric vehicle loans/leases or solar leases) or loans are utilized for green projects. A third option is that note proceeds are used to invest in green projects.

Issuance has significantly expanded in the last few years but still represents only a very small part of the overall securitization market. To help ensure that green securitization is true to its name, the European Banking Authority has recommended that the scope of the EU Green Bond Standard Regulation be amended to also apply to securitizations.

Geographic View

As ESG investing grows globally, regulatory bodies have continuously developed methods to oversee sustainable finance markets. This report updates our 2021 analysis of the depth and breadth of sustainable finance regulatory initiatives from around the globe for selected countries, based on the number of regulatory initiatives as well as the range of regulatory topics addressed.

Figure 2: European countries still lead, APAC continues to catch up, and North America increases the depth and breadth of its regulatory initiatives (Index of regulatory topics covered and number of initiatives, selected countries, for 2021 (left) and 2022 (right))

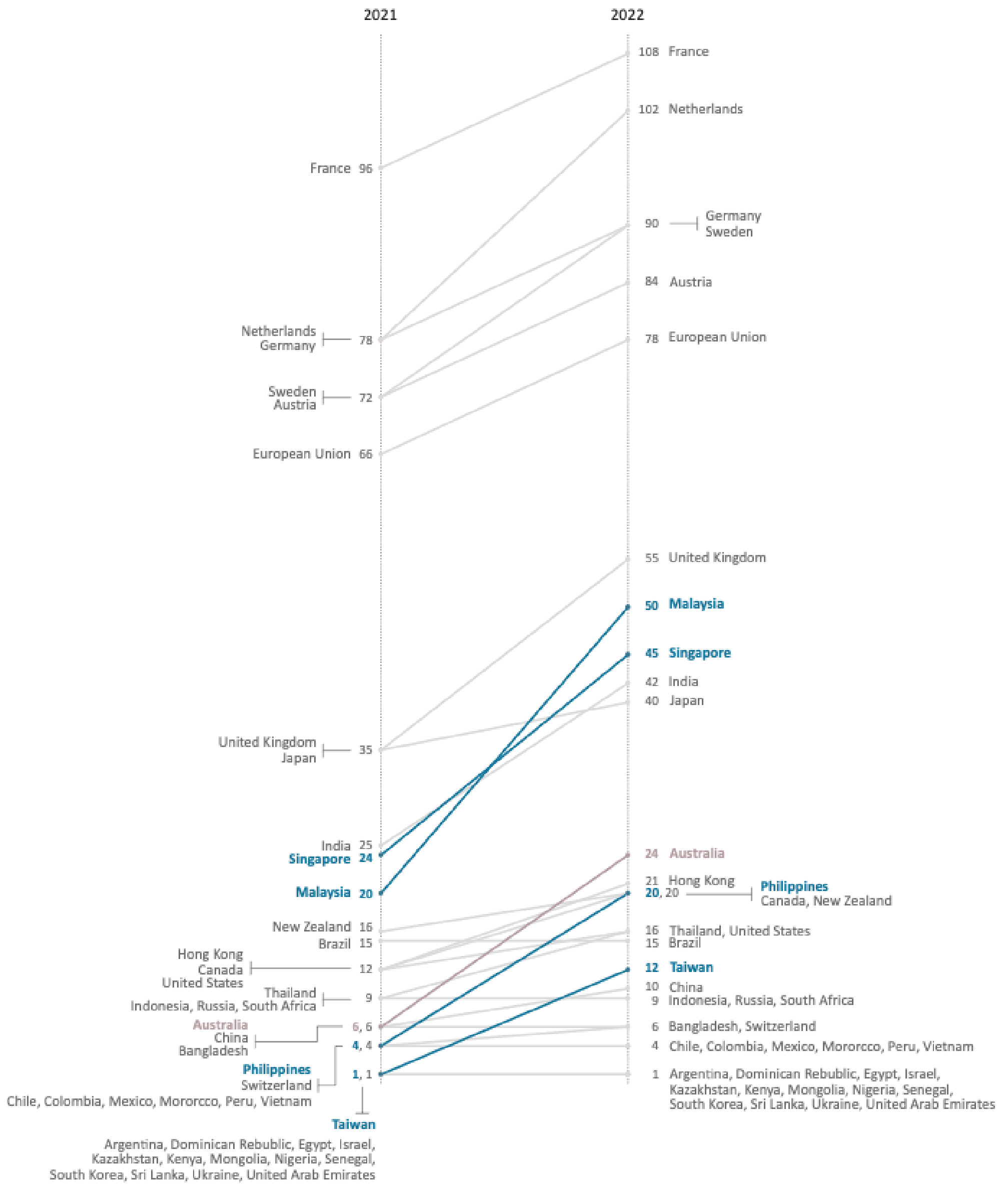


Source: ISS ESG Research

Europe

Europe maintains its status as the leading global region in terms of the depth and breadth of sustainable finance regulatory initiatives. The EU has continued to provide a benchmark for global progress in regulation of sustainable finance, outlining its path towards a sustainable economy, while individual countries within the European marketplace complement EU policy with country-specific regulatory initiatives. Meanwhile, the United Kingdom has expanded greatly upon its own regulation with the most expansive regulatory framework of any country outside the EU.

Figure 3: Jurisdictions with the highest percentage change in the depth and breadth of sustainable finance regulatory initiatives (Year-on-year index comparison, selected countries)



Source: ISS ESG Research

Challenges remain for affected financial market participants, however. While investor disclosure requirements apply in the EU, new corporate reporting requirements are not yet in force. EU regulation also contains diverging definitions of 'sustainable investment.' As for the EU's Taxonomy, the polarizing debate on whether nuclear energy and natural gas should be included, and the final decision to include the two, might have dampened enthusiasm and support for the EU's sustainable finance framework. Greenwashing concerns preoccupy European regulators, who have reacted by investigating investment funds' compliance with regulatory requirements and product claims. Further work on sustainable finance at the EU level is planned. The European Securities and Markets Authority (ESMA) has published its sustainable finance roadmap, planning up until 2024. The authority identified three priorities for its work: tackling greenwashing and promoting transparency; building the national supervisors' and ESMA's capacities in the sustainable finance field; and monitoring, assessing, and analyzing ESG markets and risks. ESMA plans to address its three priorities with a comprehensive list of actions impacting investment management, investment services, issuers' disclosure and governance, and benchmarks.

Within the EU, France, the Netherlands, Germany, and Sweden are the countries leading on sustainable finance regulation. Both the Netherlands and France have recognized the relevance of biodiversity risk. The Dutch Central Bank is developing scenarios to assess the impact of biodiversity loss on financial stability. The aim is to create a conceptual framework to take nature-related financial risks into account and include them in stress testing. French financial institutions are required to disclose how they identify and manage biodiversity risks.

Across the channel, the UK has continued to develop its own green finance plan in the aftermath of Brexit. The UK Financial Conduct Authority has recently introduced new climate-related disclosure requirements for FCA-regulated asset managers and asset owners about how they take climate-related risks and opportunities into account in managing investments. From October 2022, the Department for Work and Pensions also will require large UK pension funds to disclose how they align with the Paris Agreement's goal of limiting global warming to a 1.5°C increase. The alignment requirement is accompanied by guidance on stewardship expectations. While the development of a UK taxonomy, the Sustainability Disclosure Requirements (SDR), and a sustainable investment labelling scheme are ongoing, the recent political turmoil and the establishment of a new government have slowed down the process and created some uncertainty.

North America

The United States' landscape for sustainable finance regulation has continued to change significantly, notably with steps regarding fund and adviser disclosure and investment product labelling. In two companion proposals issued this summer, the United States Securities and Exchange Commission (SEC) aims to tackle greenwashing by amending disclosure requirements for investment advisers and funds regarding ESG investment practices and name requirements for ESG funds. The proposed rules govern the information that fund managers and advisers must provide when they market their funds as having an ESG focus. If adopted, this would bring the US closer to EU SFDR requirements.

The disclosure proposal envisages specific disclosure requirements for ESG-related funds. Funds focused on environmental factors generally would be required to disclose the greenhouse gas (GHG) emissions of their portfolio investments. Funds that claim to realize a particular ESG impact would be required to describe the intended impact and their progress toward it. Funds that rely on stewardship to implement their ESG strategy would be required to disclose information regarding their engagement with issuers, including meetings, and voting on ESG matters.

The "Names Rule" proposal would require funds whose names incorporate one or more ESG factors to invest at least 80% of their assets in investments suggested by that name.

While the consideration of material sustainability factors, specifically climate risk, in investment is generally gaining traction in the US, approaches are diverging at the state level. Several Republican-led states have pushed back on ESG investing, criticizing it as politically motivated. In Texas, state government entities are now subject to investment prohibitions and divestment requirements when it comes to financial companies that "boycott" fossil fuel companies. In July 2022, West Virginia's state treasurer barred the state from conducting business with five major financial institutions that explicitly limit commercial engagements with the fossil fuel sector. Oklahoma, Kentucky, and North Dakota have passed similar laws. Meanwhile, Florida, North Dakota, Idaho, Arizona, and Kansas are among states that have enacted or proposed legislation restricting their government entities from considering ESG factors for investment purposes.

In contrast, states such as New York and Maine are considering or have adopted legislation restricting their government entities from doing business with or investing in fossil fuel companies. Illinois is the only state thus far to have passed legislation requiring government entities to consider ESG factors in their investments.

Similar but specific to the insurance sector, by November 2022, US insurers in 15 US states will need to issue TCFD-compliant reports, according to the National Association of Insurance Commissioners (NAIC). This represents nearly 80% of the country's insurance market.

Canada has also addressed ESG investing through labelling and disclosure. The Canadian Securities Administrators (CSA) issued guidance to bring greater clarity to ESG-related fund disclosure and sales communications considering greenwashing concerns. Supervisory authorities have proposed climate reporting requirements that would require financial institutions to provide annual disclosures, conduct regular climate scenario analysis, and study the impact of climate change on their capital reserves.

In addition, the Canadian Association of Pension Supervisory Authorities has issued draft guidance on ESG considerations in pension plan management. The guidance states that using ESG information can be compatible with fiduciary duty and ignoring or failing to consider ESG factors that may be potentially material could be a breach of fiduciary duty. Pension plans should also consider how to implement effective and appropriate stewardship on ESG issues.

Canada also has a Green Bond Framework, which is aligned with the International Capital Markets Association's Green Bond Principles. It was released this year by the Department of Finance.

APAC

The Asia-Pacific (APAC) region has seen widespread growth and innovation in regulation governing transitions towards a sustainable economy. Countries throughout the region have taken unique approaches to encourage more investment in sustainable financial instruments, enhance consideration of ESG risks, and prevent firms from greenwashing their products.

Malaysia, Singapore, India, and Japan stand out as leaders. These countries cover a wide range of regulatory topics, often with more than one regulatory initiative to address each topic. The Monetary Authority of Singapore (MAS) issued its environmental risk management (EnRM) guidelines for banks and finance companies in June 2022. MAS also intends to require asset managers to make climate-related financial disclosures aligned with the ISSB, while also requiring disclosures on funds' investment strategies, criteria, and metrics.

Meanwhile, Malaysia developed a TCFD Application Guide for Malaysian Financial Institutions with key recommendations, guidance, and examples to facilitate its adoption. Malaysia's Securities Commission (SC) also published requirements for fund management to consider ESG risks in investment processes and in active ownership.

In India, IFSCA published draft guidance which outlines that all Indian IFSCA-linked financial institutions should have at least 10% of their loan assets in the form of lending to green, social, or sustainability-linked sectors. Financial institutions are also encouraged to develop internal policies on green, social, and sustainability-linked lending. The Reserve Bank of India (RBI) has asked financial institutions to address climate risks through voluntary measures such as setting green finance targets to move capital towards sectors which could help mitigate climate risks and requiring customers in emissions-intensive industries to set a sustainable energy transition strategy.

The Japanese Financial Services Agency (FSA) has recently outlined principles for asset managers with ESG funds. When a firm claims a fund has ESG characteristics, its investment approach and process should be strengthened on a continuous basis, and clear explanations and disclosures should be made in a consistent manner. Firms should also proactively conduct stewardship activities to improve ESG-related business opportunities and reduce risks.

In Australia, the change in government has signaled a shift in the country's climate policy and an increased governmental focus on sustainable finance. The Australian Securities and Investments Commission (ASIC) has made climate a priority for 2022. ASIC has also released an Information Sheet on greenwashing, which clarifies investor obligations to avoid greenwashing in sustainability-related financial products. The Australian Sustainable Finance Institute is working to develop the Australian sustainable finance taxonomy.

In New Zealand, regulators and supervisors had already been more active with, for example, guidelines on ESG product disclosures, climate-related disclosures, an ESG pension default scheme, and a taxonomy for sustainable agriculture. The Financial Markets Authority of New Zealand has also issued anti-greenwashing guidance similar to that of Australia.

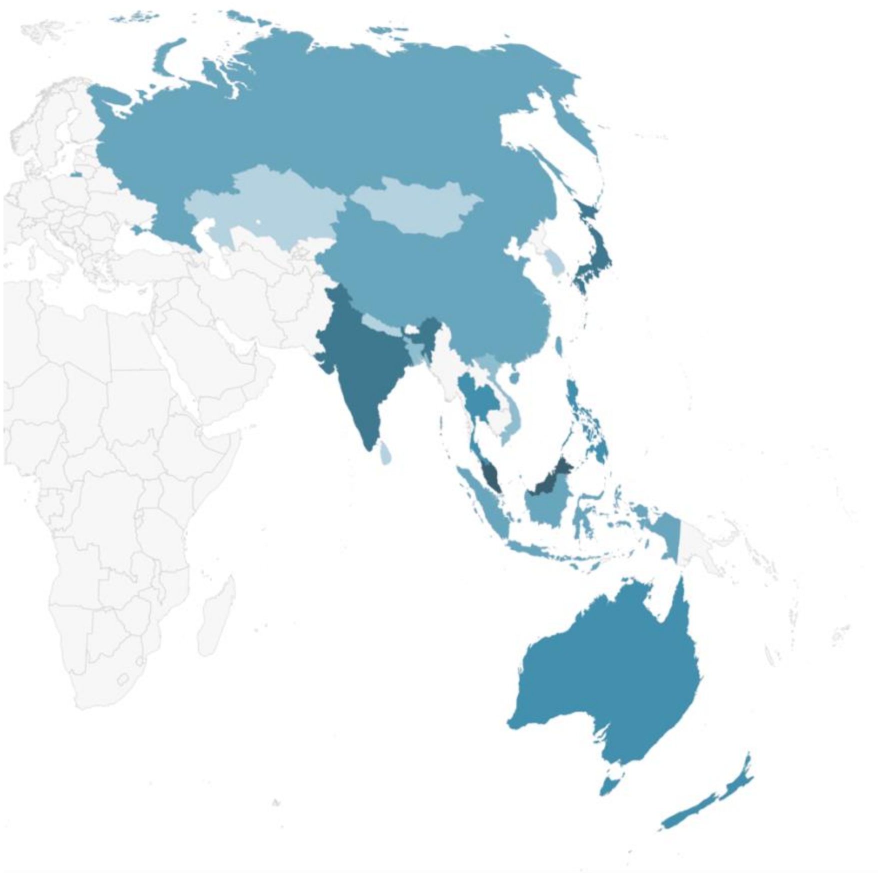
Significant developments have also occurred in other key APAC financial markets, notably Hong Kong, Taiwan, and the Philippines. The Hong Kong Monetary Authority (HKMA) set out practices for banks — reducing operational GHG emissions, reducing financed emissions, and assisting clients to transition — to promote the transition to carbon neutrality. In Taiwan, the Financial Supervisory Commission (FSC) published Guidelines on Climate-related Financial

Disclosures of Insurance Companies and announced the Transition Strategies of Sustainable Development for Securities and Futures Sectors. The latter includes strategies for underwriters and financial consultants to assist listed companies in materializing sustainability programs. The Philippines' SEC released draft rules requiring SRI funds to prove they live up to their stated ESG focus and meet minimum ESG investment standards. The Philippines' Treasury has established a Sustainable Finance Framework for bonds. All three countries' supervisors have committed to climate risk stress tests.

Meanwhile, Chinese financial regulators have set out high-level objectives for improving policy frameworks to support green finance. The objectives include formulating standards on transition finance. China already has green bond principles and a corresponding taxonomy, the Green Bond Endorsed Projects Catalogue.

Some countries have recently initiated sustainable finance efforts. Under the amended Environmental and Social Risk Management Framework of the Nepalese central bank, environmental and social risk will have to be considered by banks and financial institutions before finalizing any transaction. Meanwhile, Sri Lanka is newly developing a taxonomy. Thirteen countries now have or are developing green taxonomies in APAC, in addition to the regional sustainable finance taxonomy published by the Association of Southeast Asian Nations (ASEAN).

Figure 4: Regulatory initiative density in APAC in 2022 (Darker = more initiatives)



Source: ISS ESG Research

Latin America and Caribbean

Climate change and deforestation continue to pose a fundamental threat to many Latin American economies, whose markets intertwine with the unique geography of the region. Throughout South America, green and sustainable bond standards have been continuously developed to strengthen green investment. Some countries also have guidelines on integrating ESG risk: Peru, Brazil, and Colombia require ESG risk management by pension funds and/or banks.

In April 2022, Colombia became the first Latin American country to finalize and publish its green taxonomy. Other countries in the region are also developing their own taxonomies. The Colombian green taxonomy contains various environmental objectives, including a new emphasis on land use. The taxonomy aims to facilitate the differentiation and classification of green financial instruments, as well as to increase transparency and support the monitoring of green investment.

Another country that stands out in this region is Brazil. The Brazilian Central Bank (BCB)'s wide-ranging, mandatory ESG regulations cover a spectrum of topics including disclosure, risk management, stress testing, scenario analysis, positive impact, and governance. For example, financial institutions must consider environmental, social, and climate impacts for their financial products and services.

Africa and the Middle East

Climate change seriously threatens both living conditions and economic development throughout the African continent. African countries continue to focus on guidance and incentivization for green bond issuances. Frameworks for this purpose exist in Morocco, Egypt, Kenya, Senegal, and Nigeria, for example.

South Africa is still leading the region in sustainable finance initiatives. In addition to mandating climate-related stress testing, the country's Financial Sector Conduct Authority guidance requires pension funds to consider ESG factors in their investments. The South African Treasury has also published its final green taxonomy, which will be formalized into regulation by the end of 2023. The taxonomy significantly overlaps with its EU counterpart, while also referring to national laws and circumstances—including how to ensure a just transition.

Throughout much of the Middle East, market participants have often adhered to Islamic/Sharia standards for financing and investing. Some countries are beginning to consider broader ESG factors. In recent years, the United Arab Emirates and Israel have both taken action on ESG disclosure and risk management practices for investors. Further sustainable finance regulatory initiatives have yet to emerge from Middle Eastern countries.

Conclusion

Sustainable finance regulation has continued to make considerable advances in the last year. Across the board of regulatory topics analyzed (taxonomies, ESG and climate risk management and disclosures, product requirements, ESG in stewardship, and green bond frameworks), new initiatives have been taken by regulators and supervisors throughout 2022. The strongest growth, however, has been in initiatives to manage climate risks as well as those aimed at preventing greenwashing through investment product standards and product-level and entity-level disclosure requirements.

Implementation of regulatory initiatives varies between and within regions. Europe continues to be the leading region in depth and breadth of regulatory initiatives on sustainable finance. Within Europe, France, the Netherlands, Germany, and Sweden have the greatest regulatory focus on sustainable finance. A significant increase in actions can be seen in the UK.

The Asia-Pacific (APAC) region has also significantly accelerated its regulation of the ESG investing landscape. Key countries here are Malaysia, Singapore, India, and Japan. Other APAC jurisdictions that have taken various regulatory initiatives include China and Hong Kong, the Philippines, Thailand, and Taiwan. Some countries, such as Nepal and Sri Lanka, have newly emerged onto the regulatory landscape. In the wider APAC region, the biggest shift can be observed in Australia, where a change in political direction has led to more climate considerations and sustainable finance-related initiatives.

Similarly, in North America, the US has seen significantly increased interest in addressing climate risk and greenwashing through regulation. Canada has also broadened its regulatory scope with several initiatives. In Latin America, while several countries have green bond frameworks or ESG risk management guidelines, Brazil continues to lead the region. In Africa, where there is a predominance of green bond standards, South Africa continues to stand out with a broader range of actions. Finally, the Middle East has yet to see significant regulatory activity on sustainable finance.

Throughout the globe, sustainable finance regulation is constantly moving and advancing, with new plans and proposals being announced and often published for consultation and stakeholder reviews. Next year will likely bring more regulatory initiatives to increase the transparency of the sustainable investment market and support a transition to more sustainable societies and economies. Sustained regulatory scrutiny of the risk of greenwashing by corporate issuers and investors and in investment products may well be central to these initiatives.

Considering the nexus of geopolitical tensions and economic volatility, sustainable finance regulation could play a significant role in fostering economic and energy resilience in the long term. Such a role may be in tension with the increasing politicization of sustainable investment and ESG factors, however. Those in the sustainable finance sphere might need to defend their strategies and approaches at times. The ESG regulatory journey continues.

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