Climate change and finance: What's next for global regulators?
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Today I want to talk about the urgent need to retool the financial system to address the threat of climate change, focussing on some of the major efforts now underway to move us more quickly in that direction.

These efforts show considerable promise, but I believe we are now in a crucial few months which will set the direction for years to come.

To make real progress, we must be clear-eyed about the obstacles we have to tackle, and how we might do so.

Today I am speaking as Chair of the International Organization of Securities Commissions (IOSCO), the global organisation of securities market regulators. Our members fully recognise that an overarching challenge is how to reorient the information flowing through the financial system so that it better supports capital allocation and investment decisions to support a managed transition to a low carbon economy.

We are only too well aware that differing sustainability reporting standards, and the voluntary and high-level nature of many of these frameworks, have resulted in sustainability and climate change disclosures that are inconsistent and at times misleading. For securities regulators, this challenges our ability to meet a core objective which is to ensure that markets operate efficiently based on accurate disclosure of the material financial risks affecting businesses.

Many of these challenges revolve around the availability of relevant, reliable data. Unfortunately, the sustainability information which is now being disclosed is often wildly inconsistent: clear definitions have not yet been agreed at a global level, and there are no standard methodologies.

This can lead to cherry-picking and shopping around for reporting standards or ratings so that sustainability disclosures look as good as possible. This makes greenwashing easier, which then raises questions about the credibility of the whole climate disclosure effort.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

At a more basic level, there are as yet insufficient incentives to drive fundamental behaviour change, and solutions for this will be crucial.

Having said that, the main components of future global cooperation are now in place.

Nearly three years ago, IOSCO set up a Sustainability Task Force and since then we have been addressing these issues head-on. Two important areas of focus have been on asset management firms and corporate disclosures, with a view to harmonising and improving the comparability of climate disclosures.

In parallel with this, the central banks' own grouping in this area—the NGFS[1]—has been looking at climate risk principles from the perspective of the prudential regulation of bank and insurer balance sheets.

And most recently, the EU's International Platform on Sustainable Finance has begun to play an important role in promoting better cooperation amongst national governments, central banks and other authorities such as IOSCO.

These are just some of the collaborative programmes now underway. It is a good start, but there is still a strong need for a more driven global effort.

Climate disclosures

One absolutely fundamental area where we can see the contours of a compelling regulatory outcome is to do with corporate-level climate disclosures.

Obviously, if investors are to take climate risks affecting different businesses into account when allocating capital, they need to have access to information which is material and relevant to their decisions as well as comparable across business sectors.

And in order to understand the outcomes they are financing, they also need to know more about how the businesses in which they invest affect climate change.

These two dimensions are crucial, as companies—as distinct from banks and asset managers—operate at the level of the real economy, and this is where business decisions have a direct impact on climate pathways.

The reality is that unless real-economy information is credible, comparable and reliable, those further up the investment chain, including banks and insurers, have little basis on which to judge their own vulnerabilities to climate risk, or the impact of their portfolio investments on emissions.

And as net-zero targets gain traction, these so-called "double materiality" disclosures—about financial risks but also about a company's own emissions footprint—take on a new significance.

From a regulatory perspective, disclosures and standards go hand in hand. So this is a natural area for IOSCO to be involved, especially as we are figuring out how securities regulators can play a role along the pathway to making climate disclosures mandatory.

[1] The Network of Central Banks and Supervisors for Greening the Financial System.

As a start, a more substantive uptake of the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) is essential. This will help companies embed a broadly accepted framework for reporting on the financial risks associated with climate change into their governance and risk management frameworks, as well as in communications with stakeholders.

And it is good to see that a number of jurisdictions have committed to align their disclosure requirements with the TCFD. We have now done so in Hong Kong, joining New Zealand, the UK and others.

IFRS Foundation proposal

But in this vital area of real-economy corporate disclosure, I also want to highlight the very important IFRS[2] Foundation proposal to establish a new, global sustainability standard-setting board alongside its existing International Accounting Standards Board.

This would initially focus on climate disclosure standards centred on the "enterprise value" of businesses. I understand that the response to the proposal was enthusiastic, and the IFRS has announced that the next step will be a definitive statement by the end of September, with a possible establishment of the new standards board at COP26[3].

The reason this proposal is so interesting is that it would build on the IFRS Foundation's proven standard-setting process for financial accounting, which rests on a rigorous governance structure to ensure public accountability and widespread acceptance. The promise is to use this framework to institutionalise the TCFD recommendations and other existing standards to create a comprehensive, harmonised reporting framework.

IOSCO is in a unique position to assist the IFRS Foundation in this effort—just as IOSCO laid the foundation for the adoption of IFRS financial reporting standards across its membership back in 2000. Today, 144 jurisdictions use IFRS.

In 2009, IOSCO worked with the IFRS Trustees to establish a Monitoring Board of public authorities, which is chaired by an IOSCO Board member. This oversees the IFRS Trustees to ensure that they discharge their duties in accordance with the IFRS Constitution. IOSCO is therefore in a prime position to help formulate and participate in a similar governance framework for climate regulatory standards.

The potential outcome is a very promising pathway to global convergence, with the ultimate aim of laying a foundation for independent assurance of climate reporting modelled on traditional financial audits.

As you probably know, an alliance of sustainability standard setters have also helpfully proposed a climate-related financial reporting prototype which can help kick-start work at the IFRS.

Overall, this is a very positive development which addresses head-on the problem of 'noise' resulting from a multiplicity of different private sector standards addressing the same market.

[2] International Financial Reporting Standards.
[3] The UK will host the 26th UN Climate Change Conference of the Parties (COP26) in Glasgow in November 2021.

Asset management

Now another major initiative for IOSCO would create pathways to mandatory investment disclosures further up the investment chain—by asset managers and also for investment products.

Securities regulators have a very firm handle on asset management firms and product disclosures because they register, license, authorise or regulate them directly. So this is an area where we can have major influence.

In Hong Kong, we have already proposed mandatory climate disclosures by asset managers. This is centred around the idea that investors need to know the extent to which their portfolios are financing emissions as well as portfolio exposures to climate risks.

IOSCO will accelerate these efforts by taking a closer look at the metrics and disclosures needed to measure these exposures and financed emissions.

By setting clearer guidance for asset managers we also aim to drastically reduce opportunities for greenwashing. In the longer term, detailed methodologies which underpin more forward-looking scenario-based disclosures and metrics, such as climate value-at-risk, are likely to be key to aligning portfolios with climate goals.

Third-party data and ratings providers

A related issue is that the industry's thirst for sustainability data will only increase, and this will make ESG data and ratings agencies even more influential. In Europe, there have been calls for better supervision, but in reality these agencies are largely unregulated.

IOSCO is looking at the emerging risks associated with the growing role of ratings. These include the transparency of processes, definitions and methodologies, as well as governance and how agencies manage conflicts of interest. This will pave the way to address some of the key concerns raised by users of this information, not least that one business may be assigned wildly differing ESG scores.

Taxonomies

Looking further out, as we see more governments, businesses and even asset management firms committing to net-zero goals, a number of additional challenges are becoming apparent. How do we measure and disclose performance, not only to tackle climate risks and greenwashing, but also to enable capital to be allocated in light of these new goals?

This is an area where taxonomies loom large, as they provide a common language to define what activities are green, brown or olive. They can indirectly mobilise investment flows to companies which are transitioning to more sustainable activities or are already engaged in them. They can also classify solutions to mitigate climate change as well as activities for achieving interim goals.

Good progress is being made. Of particular interest to us in Hong Kong is the EU's and China's project to develop a common taxonomy under the International Platform on Sustainable Finance. As with much in the climate finance area, global consistency is vital to solve a problem which does not respect national borders.

The combined economies of the EU and China add up to US$30 trillion, which is about one-third of global GDP. In one sense, this could be the largest single climate finance market, with both the EU and China having committed to a net-zero goal. And now we have the welcome prospect of the US joining the overall effort.

Incentives

As for incentives, setting a credible price on carbon, including a forward price, is a much-discussed policy tool. It would allow the cost-benefit analysis of climate action (or inaction) to be computed directly, and this in turn should lead to behavioural change. Externalities would be more accurately priced and as such, investors will necessarily demand greater transparency from businesses on their climate strategy. This should also reinforce the efforts to harmonise corporate reporting and quicken the pace along the pathways to mandatory reporting.

China has recently renewed its commitment to accelerate carbon trading at the national level for the most critical industries, and the EU is tightening the allowances under the EU Emissions Trading System.

And we now see the private sector participating more actively in voluntary carbon markets. A task force led by the private sector has made recommendations on how to scale those. And CME Group has just announced that it will launch a voluntary carbon-offset futures contract.

Regulators are alive to growing interest in this area, as well as to some scepticism about carbon offsets. We look forward to playing a more active part given that market-based finance is at the heart of what we do.

The future

To sum up, IOSCO and its counterparts are now engaged in an accelerated, far more coordinated effort to push forward the climate finance agenda in all key areas.

International organisations, national authorities and the private sector now have no real option other than to participate. If they do not, they risk being left behind as investments shift in favour those businesses which can properly describe how they are managing the strategic risks resulting from climate change.

We are acutely aware of the need for firm leadership to ensure that all stakeholders converge around credible climate finance standards which are globally applicable. To be credible, these standards must be based on an awareness of the burning need to combine insights from climate science, economics and regulation to ensure that the content of climate disclosure makes a real difference in our journey to a sustainable future.