AFMA

Sustainable Finance Stack

Over the course of the last forty years, general understanding of what the notion of 'sustainability' encompasses has evolved. In addition to the prevailing focus on addressing concerns around environmental impacts and climate change, sustainability of the economic system became a live issue after the 2007-2008 global financial crisis, and the issue of social equity increased in prominence following the launch of the 2030 Agenda for Sustainable Development by the United Nations in 2015. More recently, the outbreak of COVID-19 in early 2020 highlighted global economic, social and environmental vulnerabilities for the international community to address.

Investor support for broad environmental and socioeconomic reform is now a powerful force influencing developments across the financial services industry in response to calls to give effect to broader sustainability objectives.

Role of financial markets in sustainable finance

Green, social, sustainability and sustainability-linked bond issuance was over $600 billion in 2020, almost double the $326 billion issued in 2019[1]. With more financial institutions factoring in green principles for their underwriting and lending practices, the increase in sustainable bond issuance is expected to continue, as more issuers delve into these instruments to underscore their sustainability strategies and governments set net-zero carbon emissions commitments, amidst growing investor demand for sustainable-labelled bonds.

As financial markets face the prospect of sustainable finance moving from an emerging trend to a mainstream business strategy, a swathe of public and private sector initiatives are underway to better elucidate the "sustainable characteristics" of firms' business activity, capital raising and impact on sustainability goals. (E)nvironmental factors such as climate change and biodiversity lead the emergence of these initiatives. However, COVID-19 related developments have pushed for greater inclusion of (S)ocial and Corporate (G)overnance factors.

At the supranational level, the International Capital Market Association (ICMA) has released helpful market guidance through its principles, guidelines and handbooks that assist issuers in understanding best practices of determining eligibility for sustainable finance. The United Nations

[1] Sustainable Bonds Insight 2021, *Environmental Finance*, 2021.

Principles for Responsible Investment (PRI) also provide possible actions for incorporating ESG issues into investment practice. At a regional and national level, the EU and China have vigorously progressed to develop sustainability-related taxonomies.

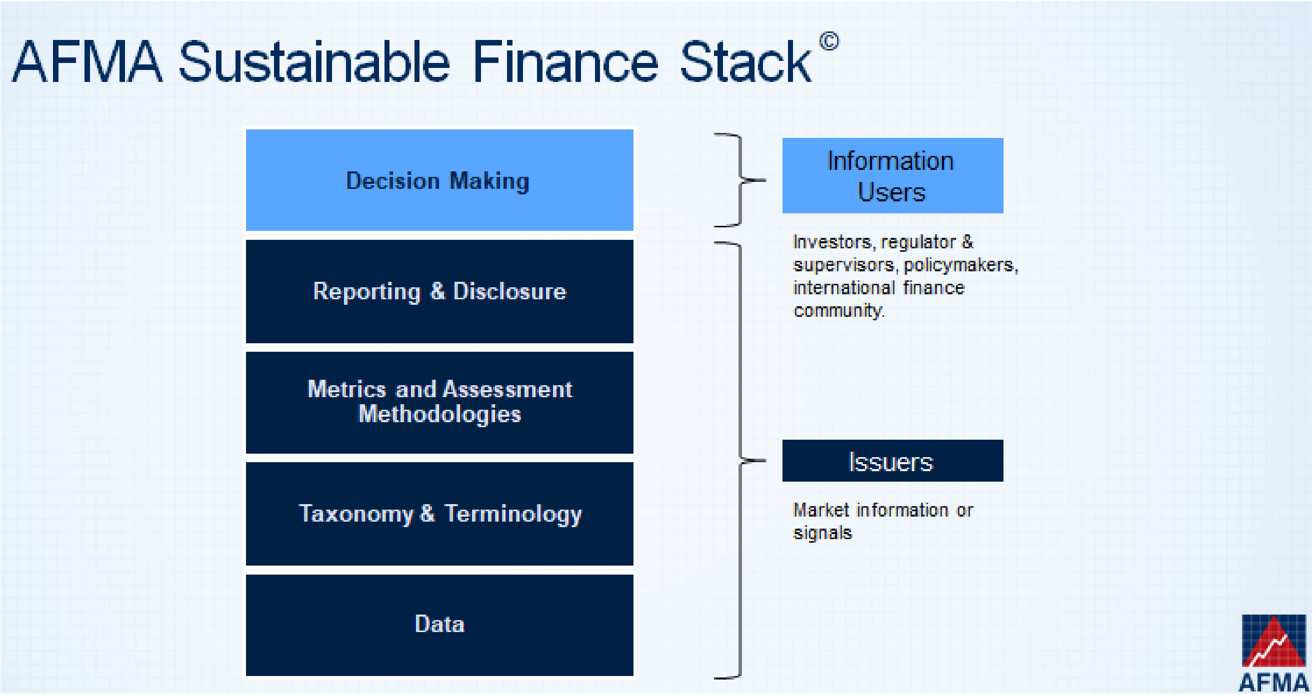
Governments are introducing major changes to disclosure requirements to implement Task Force on Climate-related Financial Disclosures (TCFD) recommendations, as seen last year when New Zealand took steps to mandate climate risk reporting by financial institutions, with the United Kingdom and Hong Kong looking to follow suit. Meanwhile, private institutions are working to evaluate ESG risks by creating ESG-ratings and scores such as MSCI and some not-for-profit entities offer verification and certification schemes.

While certain initiatives offer essential international benchmarking, the proliferation of multiple guidelines, indicators, evaluations, and requirements has led to market confusion and uncertainty around reliability of available information. The absence of consistent understanding among financial market participants creates a range of risks associated with greenwashing, unsubstantiated claims of sustainability and the use of dubious assessment methods. Importantly, the present uncertainty around notions of sustainable finance means that firms are facing heightened legal and litigation risk due to a lack of consensus around what constitutes ESG and how to measure compliance with ESG goals.

AFMA streamlining and harmonising

As an industry association with a mandate to promote efficiency, integrity and professionalism in the Australian financial markets, AFMA's approach to the domain of sustainable finance is based on streamlining and harmonising market practices. AFMA's broad membership consists of Australian and international banks, leading brokers, securities companies, state government treasury corporations, fund managers, energy traders and industry service providers. As pressure mounts on the financial services industry to deliver on sustainability outcomes, AFMA is fulfilling its role by considering existing and upcoming market practices and supporting a coherent market structure for all participants and stakeholders. AFMA has developed an analytical market framework to conceptualise sustainable finance market practices, in the form of the AFMA Sustainable Finance Stack (the Stack) (Fig.1).

Figure 1

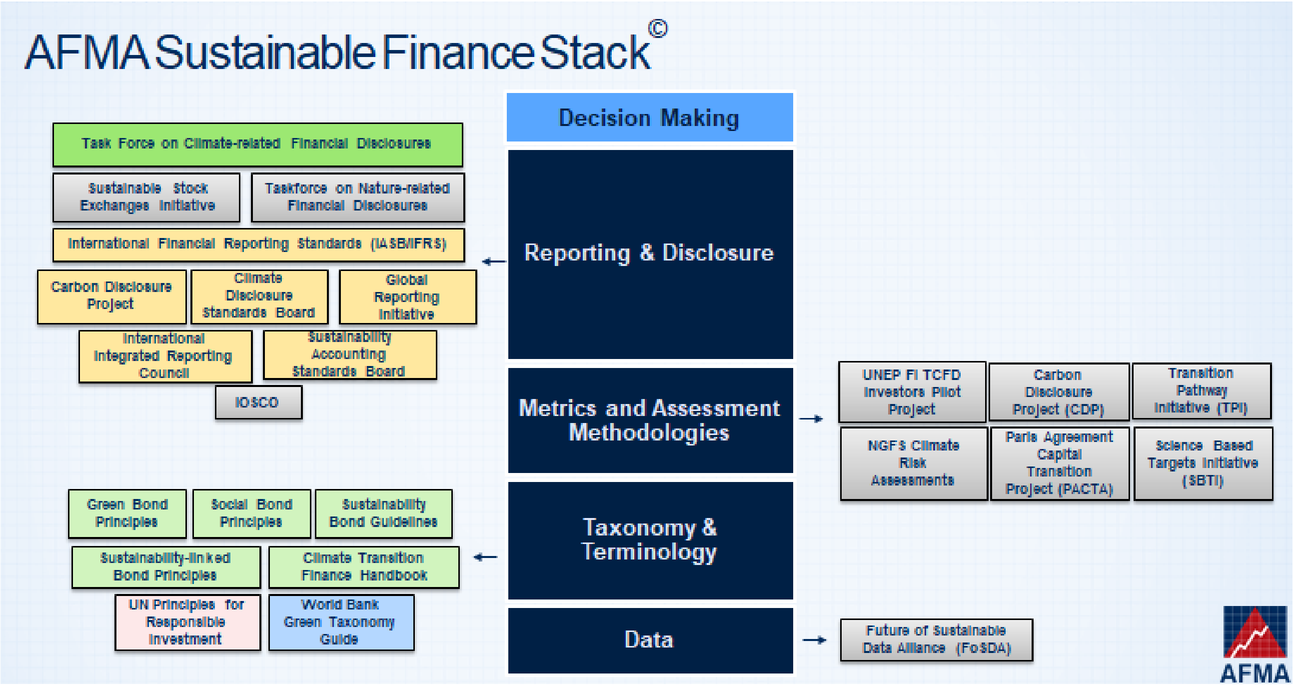


SOURCE: AFMA (2021)

Demarcating the aspects of sustainable finance to provide clarity on how the various developments underway fit together, the Stack classifies information resources, benchmarking initiatives and expectations for business practices into five separate streams of data, taxonomy and terminology, metrics and assessment methodologies, reporting and disclosure and decision making. Together, these form the primary layers of the Stack.

The Stack assists market participants in mapping those elements to key international best practice initiatives to facilitate the conversation on those elements and reduce the confusion created by multiple developments. The following diagram illustrates such mapping (Fig. 2).

Figure 2



SOURCE: AFMA (2021)

The Stack also helps to analyse how the market framework and the mapped international initiatives can be considered in the Australian context given the distinctive characteristics of the Australian economy. This will help open up a more structured dialogue for sustainable finance market practices in Australia that caters to the Australian environment while allowing international interoperability.

Governments and regulators around the world are exploring ways to standardise and regulate sustainable finance market requirements across the elements of the Stack. As industry leads the way in structuring business activities to achieve various sustainability goals, best practices for data, taxonomy, assessment methodologies, accounting and reporting are still being developed. To avoid unfavourable outcomes and strike a balance between business and sustainability objectives, it is important that sustainable finance is integrated into the economy in a clear, consistent manner. It is hoped that the Stack, by providing a clear structure for market participants to reference, will facilitate decision making on matters of sustainable finance across the finance community.

For further information about AFMA's sustainable finance initiatives, contact Nikita Dhanraj, Policy and Research Officer, AFMA.