*Internetowy Przegląd
Prawniczy TBSP UJ 2019/4
ISSN 1689–9601*

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Financial Regulation and Sustainable Development

Abstract:

Every human being has the right to participate in, contribute to and enjoy economic development. To protect the realization of this very right the United Nations made a blueprint of sustainable development goals, so-called Agenda 2030. Although the goals are interconnected, some of them seem to be unachievable simultaneously. Even though there is a significant empirical evidence that industry is one of the biggest polluters worldwide, countries are obliged to combat climate change (the 13th goal) and to develop industry (the 8th goal). To overcome this inconsistency, the incentives for investing in environmentally-friendly undertakings should be created.

My text aims to analyze the European Commission's Action Plan on financing sustainable growth. I will briefly discuss its main goals, then I will give more details on those actions which are focused on participants of financial markets. I will also demonstrate changes in Markets in Financial Instruments Directive proposed by the European Securities and Markets Authority. The aim of these changes is to accomplish the Commission's goals. I will also briefly discuss the Commission's proposal to incorporate sustainable development issues in macroprudential regulation.

Since 2011 there is a regulation making banks integrate sustainable development issues in their investment process. I will briefly discuss the most crucial issues of Bengali regulation and compare them with the European proposals. In my opinion, the regulation of Bangladesh Bank seems to be more efficient.

Key words: sustainable development, finance, macroprudential regulation

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1. Introduction

Article 1 of the Declaration on the Right to Development[2] statutes that „every human person and all peoples are entitled to participate in, contribute to, and enjoy economic, social, cultural and political development, in which all human rights and fundamental freedoms can be fully realized". This very right shall be realized by taking by states all necessary actions to ensure for everybody *inter alia* health care, housing and fair distribution of income. Furthermore, states should also cooperate aiming to promote the new economic order based on interdependence and mutual interest.

The declaration, however, does not include any mechanism which could protect its goals. „Unprotected" human rights are just political declarations. The political declaration could, of course, pave the way for an important social or economic change but the risk involved in not having such a mechanism must be taken into account. For example, under some conditions, the declaration could be breached without any consequences, because declarations are not usually enforced in court or a formal procedure[3]. Even if a little chance of suffering ostracism from the international community would prevent the state from breaching the right, it was still possible that the general terms of the declaration could be understood differently by the parties of the declaration.

This problem was answered by the United Nations (UN) which set the Development Goals. At the end of the second millennium in the 2000 world leaders made a statement to start a global anti-poverty movement. As Ban Ki-Moon, UN Secretary General noted this promise: „[the statement] was translated into an inspiring framework of eight goals and, then, into wide-ranging practical steps that have enabled people across the world to improve their lives and their future prospects"[4]. The eight goals mentioned are the Millennium Development Goals (MDGs). Seven of them addressed issues regarding public health (for example combating HIV/AIDS, reducing child mortality or improving maternal health), gender equality or environmental problems, the eight goal – creating a global partnership for development – was the political one.

The MDGs came to their deadline in 2015 and were mostly treated as a success[5]. Their momentum was used to create the new more ambitious goals – Sustainable Development Goals (SDGs). The weakness of the SDGs, however, is that they are too complex and sometimes seem to be unachievable at the same time.

One of the targets of the 9th goal suggests that the states shall rise the industry's share of employment and gross domestic product. At the same time, the 13th goal aims to fight climate change. The problem is that… the industry is the biggest polluter.

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2 Declaration on the Right to Development adopted by the General Assembly (UN) resolution 41/128 of 4th December 1986.

3 M.M.T.A. Brus, *Soft Law in Public International Law: A Pragmatic or a Principled Choice? Comparing the Sustainable Development Goals and the Paris Agreement* [in:] *Legal Validity and Soft Law*, ed. P. Westerman, J. Hage, S. Kirste, A.R. Mackor, Springer Verlag, 2018.

4 United Nations, *The Millenium Development Goals Report 2015*, New York 2015, p. 3.

5 *Ibidem*, p. 9.

While SDGs are not legally binding and the Paris Agreement forces the climate action, the states are likely to limit their proindustrial action every time it could interfere with the realization of the Paris Agreement. The industry, however, plays an important role in the global economy and limiting it would have a negative impact on the whole society. This problem might seem to be answered in targets 9.1 and 9.4 of the 9th goal. The aim of these targets is to build „sustainable and resilient infrastructure", which is not defined, though might be understood as a support for transition to the green economy. Furthermore, measurements of target 9.1. are not sufficiently quantified[6]. The only possible solution of this problem is to make the industry more environmentally-friendly. This would be very expensive, so it raises the question of how we could finance the transition to the green economy.

In my opinion financing this transition will be impossible without strong and efficient regulation. In this text I will discuss the European Commission (EC) Action Plan on Sustainable Finance and the proposal made by European Securities and Markets Agency (ESMA) regarding changes in the Delegated Regulation to Markets in Financial Instruments Directive (MiFID II). I will compare these solutions with the one used by the Bangladesh Bank – the central bank and financial authority of Bangladesh. Such a comparison is useful because Bangladesh was the first country to adopt sustainable finance regulation and one of a very few which have done it so far.

2. Financing environmentally-friendly initiatives

The previously mentioned Paris Agreement[7] obliged its parties to reduce their greenhouse gasses emissions. Under Article 3 of this agreement developed countries are burdened of leading the fight against climate change by undertaking economy-wide absolute emission targets. They also have to mobilize the climate finance from a variety of sources, instruments and channels (art. 9 sec. 3) and to provide financial resources to developing countries (art. 9 sec. 1).

From the perspective of the EU Member States, most of which are developed countries, these obligations are of utmost importance. Although the EU countries have been leading the global transition to a low-carbon economy so far[8], there is still a lot of work to be done. The European Commission estimates that our investments shall be increased by €170 billion yearly to reach our sustainability goals in the energy sector alone[9]. And the energy is not the only area that needs to be changed. Neither agriculture nor industry is sustainable today.

[6] A. Tukker, *SDG 9* [in:] *Review of targets for the Sustainable Development Goals: The science perspective*, International Council of Science, Paris 2015.

[7] An agreement within the United Nations Framework Convention on Climate Change, contained in the Report of the Conference of the Parties of this framework convention, FCCC/CP/2015/10/Add. 1, https://unfccc.int/files/meetings/paris_nov_2015/application/pdf/paris_agreement_english_.pdf, 22.06.2019.

[8] High-Level Expert Group on Sustainable Finance, *Financing a sustainable European economy. Final Report 2018*, 2018, p. 2.

[9] *Ibidem*, p. 9.

Even though we have strictly defined goals, the means are still unclear. First of all, one must emphasise that the amount of money needed is too high to be covered by the public sector alone[10]. Nevertheless, in the previous years it was the EIB and National Public Banks and Institutions that paid for plenty of the „green infrastructural projects"[11]. It seems that encouraging the private sector to finance environmentally-friendly initiatives is the biggest challenge in front of the regulator.

One can divide designing a proper regulation into a few steps. Firstly, the regulator ought to set its objectives. Then, it should decide how these objectives will be achieved. Typically, the regulator can choose between direct action (i.e. using public funding to provide solutions needed) or design strategies. These strategies can be explained in a way of the metaphor. Let us assume that the market can be compared to the street in the city center. Some drivers would like to park on the sidewalks because they do not want to park at the expensive underground car park. The cars parked at the sidewalk, however, are very problematic for the inhabitants and passerby. For some of them, such as mothers with strollers, it would be almost impossible to pass by a parked car. The mayor, or in our metaphor: the regulator, who wants the streets to be more friendly for mothers with children rather than drivers, decided to erect concrete bollards. These bollards will prevent drivers from parking on the sidewalk. Our regulator used a design strategy to achieve its goal[12].

As mentioned before, funding of the transition to a low-emission economy is beyond states' capacity. So, the only reasonable choice is to use one of the strategies. The strategy which is the most common among the theorists of regulation today is the nudge strategy. Frankly speaking, since 2017 when Richard Thaler[13], who co-invented this strategy, received Nobel Memorial Prize in Economic Sciences, „nudges" have become the buzzword.

Behind the „nudge strategy" one can understand „structuring the architecture of decisions (…) so that it is easier for consumers or others (such as regulatees) to act in ways that are beneficial"[14]. If the regulation complies with the principles of the nudge strategy, it will not use just simple prohibitions. In many cases it will use a complicated system of incentives and disincentives. Sometimes the consumers or regulatees, or citizens would not even realize that they are objects of social engineering.

The nudge theory implies that every regulatee should be able to opt-out from the regulation easily. One of the classic examples of the regulation which keeps the principles of the nudge theory is the regulation of the transplantation[15]. According to Article 5 section 1 of the Polish Act on Collection, Storage and Transplantation of Cells, Tissues

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10 *Ibidem*, p. 2.

11 *Ibidem*, p. 35.

12 In this paragraph I am expanding the example given in R. Baldwin, M. Cave, M. Lodge, *Understanding Regulation. Theory, Strategy and Practice*, Oxford University Press, 2012, p. 122.

13 See for example R. Thaler, C.R. Sunstein, *Nudge*, Yale University Press, New Haven, MA, 2008.

14 R. Baldwin, M. Cave, M. Lodge, *op.cit.*, p. 123.

15 R. Thaler, C.R. Sunstein, *op.cit.*, p. 177–179. Authors are analyzing the German regulation, which is very similar to the Polish one, which I am using in the example.

and Organs[16] the organs can be taken from the corpse of everybody who has not objected such a taking while being alive. This implicit consent is an incentive to act in a way seen by the regulator as a beneficiary one, however, if one does not want to be a donor, the opt-out (regulated in the Article 6 of this act) will be easy.

Some of the public intellectuals highly criticise „nudges". For example, Elizabeth Kolbert, The New Yorker book reviewer, raises the question whether we can assume that the regulator is rational, if all of us are irrational[17]. Pierre Schlag, the professor of law at the University of Colorado, goes even further – in his opinion „nudges" are ineffective if we want to balance of interests between two or more groups with contradictory goals, especially if one of the groups cannot effectively take part in the process of decision-making[18].

It is noteworthy that there is a concern about whether the nudge strategy applies to the corporations. „Where potential harms may emerge from the cumulative actions of numbers of decision-makers, the nudging of particular decision-makers may not suffice to control the harm's emergence. This suggests that nudging has limited potential, especially in those industries where production chains are complex and extended"[19]. Sustainable finance regulation will set rules for the market, where financial instruments (bonds or equity) are both issued and bought by corporations. Having said that one must notice that using the nudge strategy for sustainable finance will probably end as a failure.

It shall be noticed that the regulator from our metaphor definitely is not respecting the principles of the nudge strategy. What is more, for the situation we were talking about in the metaphor, the nudge strategy seems to be irrelevant. The mayor did not want just to discourage most of the drivers from parking on the sidewalk, he wanted to discourage all of them. In such a situation, the possibility of the opt-out and the small amount of free will could make the goals of regulation unachievable. The second reason why the mayor did not use the nudge strategy was the fact that the one group of stakeholders (i.e. passerby) cannot effectively negotiate with the second one (i.e. drivers). It is very important from the sustainable finance point of view. One of the main ideas behind sustainable development is intergenerational equity. This principle means that „that in their development choices states must preserve the environmental capital they hold in trust for future generations and ensure that it is transmitted in conditions equivalent to those in which it was received"[20]. Future generations cannot negotiate, so as it was mentioned before the nudge strategy might be inappropriate.

[16] Ustawa z dnia 1 lipca 2005 r. o pobieraniu, przechowywaniu i przeszczepianiu komórek, tkanek i narządów (Dz.U. z 2017, poz. 1000 with later amendments).

[17] E. Kolbert, *What was I thinking?*, The New Yorker, 25th February 2008, https://www.newyorker.com/magazine/2008/02/25/what-was-i-thinking, 12.08.2019.

[18] P. Schlag, Nudge, *Choice Architecture, and Libertarian Paternalism*, Michigan Law Review 2010, p. 920–922.

[19] R. Baldwin, M. Cave, M. Lodge, *op.cit.*, p. 125.

[20] V. Barral, *Sustainable Development in International Law: Nature and Operation of an Evolutive Legal Norm,* The European Journal of International Law 2012, vol. 23, no. 2, p. 380.

As the High-Level Expert Group on Sustainable Finance has noticed, financing sustainable development implies a shift in the time preference of the investors. Today many of them want to get the profit over a time horizon where the economic returns cannot even materialise[21]. The investors who are looking for strategic fundamentals rather than near-term profits would never put their money on the green economy projects. Firstly, environmentally-friendly investments are usually industrial or infrastructural ones. These investments usually are taking a lot of time to be built and then they are bringing fruits for a long period. They are usually financed by debt and if the debtor does not want to roll over his debt many times, the debt will be a long-term one. Long-term debts (for example 5- or 7-years corporate bonds) are usually risky, so they will be unsuitable for the investors who are looking for a quite safe portfolio. Such a debt is unsuitable for profit seekers who are looking for a possibility of arbitrage.

Concluding, the regulator ought to change the habits of the investors. It could be done in many ways using, for example, the fiscal policy (lower taxation on profits from green investments) or the macroprudential one (lower bank capital requirements for assets such as green bonds).

Keeping in mind experts' advises the European Commission (EC) has prepared the Action Plan on financing sustainable growth[22]. In this plan, the EC presented ten actions to be taken aiming to achieve sustainable development goals. These actions can be divided into three groups: those which are supposed to reorient capital flows towards a more sustainable economy[23]; those which are supposed to integrate sustainability with risk management[24]; and those which are supposed to foster transparency[25]. I will describe shortly the most interesting proposals.

Firstly, the Commission suggests establishing an EU classification system for sustainable activities. Such a classification would help in labelling the environmentally-friendly activities. Commission prepared the proposal for a regulation of the European Parliament and the Council on the establishment of a framework to facilitate sustainable investment[26]. According to Article 3 of the proposed regulation an economic activity will be considered as environmentally sustainable if it meets criteria such as contributing to at least one of the environmental objectives (which are defined in the Article 5 of this act), not harming any other of the objectives, complying with the technical criteria (which would be detailed in EC's delegated regulations) and – as Article 13

[21] High-Level Expert Group on Sustainable Finance, *op.cit.*, p. 10.

[22] Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic, and Social Committee and the Committee of the Regions. Action Plan: Financing Sustainable Growth, COM (2018) 97 final.

[23] *Ibidem*, p. 4–7.

[24] *Ibidem*, p. 7–9.

[25] *Ibidem*, p. 9–11.

[26] Proposal for a regulation of the European Parliament and the Council on the establishment of a framework to facilitate sustainable investment, COM (2018) 353 final.

stipulates – complying to the principles of International Labour Organisation's Declaration on Fundamental Rights and Principles at Work.

The previously mentioned objectives are climate change mitigation and adaptation, sustainable use and protection of water and marine resources, a transition to a circular economy, waste prevention and recycling, pollution prevention and control, protection of healthy ecosystems. The proposed regulation also describes (in Articles from 6 to 11) how these objectives shall be understood.

Labelling the environmentally-friendly activities is very important in the EU strategy and the European Green Bond Standard (EGBS) is the most important label. EGBS is designed to be a voluntary standard created for the issuers who want to show that they comply with the best market practices. The issuer who follows the EGBS will be verified by the external verifier with the EU accreditation[27]. It could be relevant globally, so it would be also able for the issuers outside the EU, who would decide to comply with the standard[28]. In my opinion the way this financial instrument is constructed could be somehow compared to the Fairtrade standard used for certification of goods which are friendly for both environment and suppliers from developing countries. This standard is also based on external audit and voluntary decision of the producer[29]. By such a regulation, however, the regulator does not create any incentives. It is just a solution for the issuers who are motivated to be environmentally-friendly by other factors. The EGBS might be well-suited for them but it could change the market in a very limited way.

This problem has been noticed by the Technical Expert Group on Sustainable Finance. They treat the EGBS as a basis on which new public policies will be built. These policies ought to incentivise green bond issuance[30]. The fact that even experts who designed the standard are seeing the necessity of other reforms show that without other institutional solutions the EGBS will be the revolution that stops halfway. Among the policies recommended by the expert group, one can find increasing transparency[31] or a tax reform[32]. Unfortunately, all of these recommendations are very general.

According to the EC, the other action that shall be taken is an incorporation of sustainability into financial advice. This idea is based on the MiFID II requirement, which obliges financial institutions to offer instruments that are suitable for their clients[33]. The ESMA has prepared some technical advice to the EC regarding the proper regulation of this issue. The ESMA proposes that financial institutions will have to ask the investors about their preferences on environmental, social and governance (ESG)

[27] EU Technical Expert Group on Sustainable Finance, *Report on EU Green Bond Standard*, 2019, p. 23.

[28] *Ibidem*, p. 57.

[29] Fairtrade Labelling Organisations, *An Inspiration for Change*, Bonn 2007, p. 9, https://www.fairtrade.org.pl/wp-content/uploads/2016/08/publ_7_flo_ar2007.pdf, 19.08.2019.

[30] EU Technical Expert Group on Sustainable Finance, *op.cit.*, p. 25.

[31] *Ibidem*, p. 44–45.

[32] *Ibidem*, p. 49.

[33] Communication…, p. 6–7.

issues. According to ESMA's proposal, ESG issues should be as important as the risk/reward profile[34].

Such an assumption is, in my opinion, unrealistic. Even though the pressure from society could be very important during the process of decision-making, for most of the institutional investors return on investment will be the most important factor. The reason why the profit is so important is very easy – the remuneration of the company's directors depends on profit. What is more, also the investors must prefer being socially responsible than more profitable. Just asking the clients without other incentives will not be, in my opinion, as efficient as they are supposed to be.

On the other hand, there is a way in which a similar solution could work. The Article 173 (VI) of The French Energy Transition for Green Growth Act[35] statutes that all investment companies have to let clients know how ESG parameters are implemented into the company's investment strategy. If a company does not implement the strategy, it must explain its behaviour. This is a classic name-and-explain strategy. The main advantage of such a strategy is that under some conditions it could be shaming for those who do not comply. If most of the institutional investors comply with the rules, those who do not will found themselves under the critique of the public opinion. This regulation complies requirements of the nudge strategy: regulatee has a possibility of an easy opt-out, however, it is motivated implicitly to act in a way that will be beneficial to all. Here there is no *praescriptio iuris* (like in organ donations), but the corporate governors, who know that their companies could comply or be punished, and who know that with the punishment of their companies their remunerations are punished too, will never decide not to comply. Unless they would make an agreement, which would be, of course, the violation of the competition law and has, therefore, a really small probability. As one can see, „nudges" might be efficient while regulating corporations only when opt-out is punished. The French solution, unfortunately, seems to be better than the one proposed by the ESMA.

To sum up, most of the proposed EU regulation regarding sustainable finance is voluntary. Furthermore, it does not create strong incentives to act in an environmentally-conscious way. Even though the experts realize that these voluntary instruments require an institutional environment to work properly, the EC does not create any significant incentives.

There is, however, the one significant exception I would like to discuss now.

3. The macroprudential regulation to the rescue?

The eight action proposed by the Commission is the incorporation of sustainability into prudential requirements. For me it is the most interesting proposal made by the EC.

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[34] ESMA, *Final Report. ESMA's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II*, 2019, p. 20–21.

[35] La loi no 2015–992 du 17 août 2015 relative à la transition énergétique pour la croissance verte.

In the IMF's organising framework of the macroprudential policy[36] we can find a very simple definition of the macroprudential policy: it is a policy aimed at maintaining financial stability[37] by using prudential tools to limit systemic risk. The systemic risk is „a risk of disruptions to financial services that is caused by an impairment of all or parts of the financial system and can have serious negative consequences for the real economy"[38]. Such a disruption we could see in the late 2000s when the global financial crisis occurred.

Among the various causes of this crisis, the most important one was too high financial leverage of the financial institutions. The financial leverage could be broadly defined as usage of external financing (such as debt) to make expected profits (but also potential losses) of the undertaking higher[39]. The leverage is usually described by the debt-to-equity ratio – for financial institutions at the beginning of the crisis this ratio was very high (Lehman Brothers had 31 to 1)[40]. If the company has such a high leverage ratio, even a little drop in the value of their assets could destroy them.

There is, however, one good reason to take this risk. Debt is much cheaper than equity, so the less equity you have, the more profitable you are. No one should be, therefore, surprised that financial institutions want to have a high leverage ratio as possible. Highly leveraged institutions, however, can go bankrupt easily. Because of their interdependence, every bankruptcy generates the possibility of next bankruptcies, so it generates systemic risk. Limiting systemic risk is the main objective of macroprudential regulation. Therefore the main tool of the macroprudential policy is the regulation on capital requirements.

In the EU minimal capital requirements are defined in Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms[41] (hereinafter: CRR). The CRR divides financial institutions' capital on Tier 1 capital and Tier 2 capital. The Tier 1 capital consists of financial instruments such as *inter alia* shares, perpetual bonds or retained earnings. The Tier 2 capital consists of capital instruments which are superior to the Tier 1 ones (i.e. in case of insolvency Tier 1 instruments are ranked below Tier 2 ones) and subordinated loans (i.e. loans that ranks below other loans if the company is insolvent). According to Article 92 of the CRR, the minimal Tier 1 capital requirement is 6% and the minimum total capital (i. e. Tier 1 + Tier 2) requirement is 8% of the total risk exposure (which could be also described as risk-weighted assets, RWA).

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36 IMF, *Macroprudential Policy: An organizing framework*, 2011.

37 *Ibidem*, p. 7.

38 *Ibidem*.

39 T. Berent, *Ogólna teoria dźwigni finanasowej* (The General Theory of Financial Leverage), Warsaw 2013, p. 414.

40 L. Kotlikoff, *Jimmy Stewart is dead*, Hoboken, NJ, 2010, p. 29.

41 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26th June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, Official Journal of the European Union 2013 L176/1.

RWA is calculated in a very sophisticated way. By using advanced statistical tools financial instruments are divided into groups (quality steps) dependent on their riskiness. Take the valuation of the risk of credit for a corporation for example. According to Article 122 of the CRR, the credits would be divided into six quality steps. For very reliable debtors, the risk weight is only 20%. The risk weight on credits of debtors who have a very high probability of default is set at 150%. Most debtors have neither very high nor very small probability of default, so their risk weight will be either 50% or 100%. Some of the debtors such as small and medium enterprises and natural persons are too small to have their riskiness properly calculated, so their risk-weight will be (as a rule) 75%[42] unless their debt is mortgage-backed – in such a case risk-weight could be just 35%[43]. The capital requirement is, therefore, eight percent of the sum of all assets weighted by their risk.

By setting the risk weights the regulator can conduct its economic policy. To understand why it is possible, a few facts need to be reminded. Banks are not just lending money from party A to party B. Giving a loan is as a matter of principle just an accounting operation, by which both bank's assets (money it will get from the debtor) and liabilities (the bank will have to pay the money to the debtor) are raised. During the economic boom a bank could easily get money when needed (i.e. it has to pay a debtor) as a loan from the interbank market (so it pays its liabilities by incurring other liability). Loans from the interbank market are much cheaper than the long-term loans or the equity, so by using this strategy a bank can increase its margin (the interests they will get from the debtor minus their cost of capital). As a result, it is incentivised to behave in this way by its profit and loss account. The minimum capital requirement is a limit for this behaviour. And the risk weights are, therefore, a very powerful instrument of the policy.

The bank seeks for the investment with as low risk weight as possible. Let us assume that the bank can choose between two investments – the investment A and the investment B – with a similar risk/ return profile. The risk weight of investment A is 25% and one of the investment B is 75%. Obviously, the bank would choose investment A, because it has lower costs and has a similar expected return. From the point of view of financial stability, i.e. the principle of the macroprudential regulation, such a difference would be a catastrophe. It will reorient cashflows from the one sector of the economy (the sector of „B-like investments") to the other one (the sector of „A-like investments"). Too much money in some parties of the economy and lack of money in the other one usually results in high instabilities and – in a worst-case scenario – economic crises. Otherwise, the situation of sustainable finance is unusual, because the regulator does want to reorient cashflows. The macroprudential policy, the one and only systemwide solution affecting how financial resources are allocated, is the most powerful mean to achieve this goal.

42 Article 123 of the CRR.

43 Article 124 section 3 of the CRR.

Bangladesh Bank, the Bengali central bank and financial regulator, is the world's pioneer of integrating sustainability with the financial regulation since 2011[44]. The goal of the Bangladesh Bank guidelines is to mitigate social and environmental risk – in the country which experienced rapid industrialisation in recent years the control over these risks is even more important than in Europe. The 2011 guidelines were revisited in 2017 aiming to guarantee the achievement of goals set in governmental 10-year Perspective Plan, National Sustainable Development Strategy and 7th Five Year Plan of Government of Bangladesh[45].

The Bengali regulation lies between macro- and microprudential one. It is certainly achieving the goal of macroprudential policy (i.e. mitigation of the systemic risk), though by the classically microprudential means (i.e. concentrated on the single exposures rather than the bank as a whole).

According to the Bangladesh Bank's guidelines, every loan proposal must be firstly screened whether the initiative to be financed is included on the exclusion list[46]. If it is, a bank cannot give a loan. Such a solution might seem controversial, however, most of the excluded activities are illegal ones[47].

If the bank can give a loan, it can either give a loan or (in some sectors) will be obliged to check the ESG issues on the provided checklist[48]. This checklist differentiates, for example, between the situation in which the client has addressed NGOs protest and has not done so. When the bank completes the checklist, it receives the risk classification of the loan. The low-risk loans can be given easily[49], the medium- or high-risk ones could be given only under some conditions. Firstly, the identified risk ought to be mitigated. Borrowers usually do not have any influence on actions taken by debtors (or bond issuers) whose behaviour, however, could affect the riskiness of the debt. Therefore, there is a common practice that some obligations and prohibitions are incorporated into the legal arrangement between debtor and borrower (these obligations and prohibitions are called covenants). If the debtor does not obey the covenants, it is obliged to change its behviour within a short period or return money immediately. Under the Bengali regulation fulfilling ESG standards (such as pollution or working conditions) must be a covenant of the credit[50]. Secondly, medium-risk loans must be approved by the heads of department and high-risk ones by the board of governors[51]. Escalating the simple business decision to the top management could be treated as a disincentive.

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[44] Bangladesh Bank, *Guidelines on Environmental & Social Risk Management (ESRM) for Banks and Financial Institutions in Bangladesh*, 2018, https://www.bb.org.bd/aboutus/regulationguideline/esrm_guideline_feb2017.pdf, 26.06.2019, p. 2.

[45] *Ibidem*, p. 3.

[46] *Ibidem*, p. 9.

[47] *Ibidem*, p. 22.

[48] *Ibidem*, p. 9–10.

[49] *Ibidem*, p. 18.

[50] *Ibidem*, p. 38.

[51] *Ibidem*, p. 18.

Alongside with microprudential means, the Bengali regulation also uses the macroprudential ones. Having a high environmental and social risk at the portfolio level impacts a bank's CAMELS rating (this rating checks the general standing of the bank) and as a result bank's capital requirements[52].

The Bengali regulation is certainly not a nudge one. In my opinion, it addresses some of the nudges' weaknesses. Firstly, in Bangladesh you cannot easily opt-out from this regulation (even though it is *de iure* just a guideline, a soft law), because if a bank does not obey the guidelines, its rating will decrease. Secondly, as it was put above, nudging particular decision-makers might not control harm's emergence.

The macroprudential regulation alone would work if we had many undertakings that want to make environmentally-friendly investments and nobody who wants to finance them. Otherwise, we need to nudge both financial institutions and the real economy. Some of the Bengali solutions (such as covenants) seem to be good motivators for the real economy.

The central position of the financial system in the market economy makes it the best channel to affect the behaviour of the other sectors.

The European Bank Authority set a deadline for the report on the incorporation of ESG into risk management and supervision and the report on classification and prudential treatment of assets from sustainability perspective on 2021[53]. So far no legislative proposals were made.

My suggestion is that the EBA shall check how does it work in Bangladesh.

4. Conclusions

I would like to give a few concluding remarks.

I. **Financing sustainable development is the most important issue in front of the financial regulator.** It requires a reorientation of the cash flows in the whole economy and due to its central position financial sector is the only one where the regulator can achieve that.

II. **There are no simple solutions in financial regulation.** The proper regulation is the complex system of incentives and disincentives for different parties. Every mistake in the construction of such a system will be used by the regulatees to get around the regulation. The infrastructure which will encourage systemwide change must be created. Even if green bonds are great, they will be not used without incentives to do so. So far there are no convincing and detailed proposals for such incentives.

III. **The best way to cause systemic change is to change macroprudential regulation** because it can create the incentives needed. This most promising action is, unfortunately, much less developed than the other ones. The report on possible regulation is to be completed in 2021, so we probably will have not to see the enforced regulation

[52] *Ibidem*, p. 21.

[53] S. Eley, *EBA Work Plan on Sustainable Finance*, https://www.ebf.eu/wp-content/uploads/2019/04/Slavka-Eley-Head-of-Banking-Markets-Innovation-and-Products-EBA.pdf, 26.06.2019, p. 6.

within the next five years. Such regulation also requires time to affect the economy, which would take the next few years. The EU has lost here a lot of time.

IV. **There is a lack of cooperation between the EU entities.** For example, ESMA acted as if their experts did not know the recommendations of the Technical Expert Group. Lack of consultation between entities might help think them outside-the-box, however, it makes achieving consensus more difficult. Such a consensus among experts would be beneficial if the projected regulation was criticised by lobbyists.

V. The sustainable finance regulation is an on-going issue. Because of the EU's meritocratic principles during the legislation process many documents such as action plans or reports are published. These reports could change the course of the future regulation. The Technical Expert Group's report on the green bond standard published in June 2019 contains plenty of proposals which were not made in the EC's action plan from March 2018. In my opinion the expert group's proposals are better. As it was mentioned before, report on possible incorporation of ESG measurements into risk management is set to be published in 2021. Until then we will have no full picture of the proposed sustainable finance regulation. And despite all the reports made by professionals, the European Parliament and the Council, which are the legislators, will get the final word. The final regulation will likely be completely different from this one which I try to foresee in this very article.

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Regulacja finansowa a zrównoważony rozwój

Każdy człowiek ma prawo uczestniczyć w rozwoju gospodarczym. ONZ przygotował plan działania mający na celu poprawną realizację tego prawa – Agendę 2030, zawierającą Cele Zrównoważonego Rozwoju. Chociaż cele te są wzajemnie powiązane, czasem mogą być trudne do zrealizowania w tym samym czasie. Na przykład państwa są zobowiązane by walczyć ze zmianami klimatu i zarazem rozwijać przemysł – i to mimo empirycznych dowodów, że przemysł w największym stopniu zanieczyszcza środowisko. Niekonsekwencję tę można przezwyciężyć tworząc regulacje, które zachęcałyby do inwestowania w przedsięwzięcia przyjazne środowisku.

Przeanalizowałem plan działania Komisji Europejskiej dotyczący finansowania zrównoważonego rozwoju. W niniejszym artykule przedstawiam jego główne cele, a także prezentuję postulowane przez ESMA zmiany w dyrektywie MiFID II.

Porównam także proponowane zmiany z istniejącymi w Bangladeszu regulacjami, obligującymi banki do włączania czynników środowiskowych do ich analizy biznesowej. W mojej ocenie bengalskie regulacje charakteryzują się wyższą skutecznością.

Słowa kluczowe: zrównoważony rozwój, finanse, regulacje makroostrożnościowe