DISCUSSION PAPER 4

CHAMPIONING SUSTAINABLE FINANCE IN THE DIFC

9 SEPTEMBER 2020

Structure of this Discussion Paper

PREFACE

Why are we issuing this discussion paper?

By publishing this discussion paper (DP) we hope to prompt a debate on the most suitable ways to foster the development of sustainable finance in the DIFC to serve the objectives of Dubai and the UAE while facilitating and energising the activities of the DIFC financial sector.

As a number of international standards in this field have started to emerge, alongside many industry initiatives, we wish to discuss these and hear from stakeholders whether they could be usefully incorporated in the DFSA supervisory approach and regulatory framework for the benefit of the regulated community and the wider stakeholder base. We invite all interested parties to provide their views on the issues and ideas described in this paper.

Who would be interested in this DP?

The persons to whom this DP may be of particular interest would include:

(a) Authorised Firms;

(b) Investors and customers of Authorised Firms;

(c) Issuers of securities listed on DIFC Authorised Market Institutions;

(d) Designated Non-Financial Businesses and Professions including Auditors and Single Family Offices;

(e) advisers to any of the above;

(f) other stakeholders, NGOs and interested parties.

Terminology

The defined terms in this DP are identified by the capitalisation of the initial letter of a word or of each word in a phrase below or in the Glossary Module (GLO). In all other cases, the expressions used have their natural meaning. The acronyms are set out in the Glossary section.

What are the next steps?

Please send any comments, in response to the questions set out in this paper and in Annex 1, using the online response form by **9 December 2020** and identify the organisation you represent. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments and give your reasons for so requesting.

We will review the comments received and decide on the most appropriate way to take this work forward. This might include a stakeholder survey, engagement with individual groups of stakeholders on specific topics or events to discuss this subject across various stakeholder groups. In addition, policy, supervisory or legislative changes may follow, as necessary.

GLOSSARY

ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
CBI	Climate Bond Initiative
IAIS	International Organisation of Insurance Supervisors
ICMA	International Capital Markets Association
IFSB	Islamic Financial Services Board
IOSCO	International Organization of Securities Commissions
EU	European Union
EU GBS	European Union Green Bond Standard
ESG	Environmental, Social and (Corporate) Governance
FI	Financial institution
FSB	Financial Stability Board
NGFS	Network for Greening the Financial System
OECD	Organisation for Economic Development and Co-operation
PRI	United Nations Principles for Responsible Investment
PRB	United Nations Principles For Responsible Banking
PSI	United Nations Principles For Sustainable Insurance
SDG	Sustainable Development Goals
SIF	Sustainable Insurance Forum
TCFD	Task Force on Climate-related Financial Disclosures
UN	United Nations
UNEP	United Nations Environmental Programme
UNCTAD	United Nations Conference on Trade and Development

INTRODUCTION

1. In 2015, the United Nations (**UN**) adopted the 2030 Agenda for Sustainable Development, which set out 17 Sustainable Development Goals (**SDGs**) and 169 related targets for the world governments to focus on with a view to tackling the multitude of world challenges by 2030. As depicted below, these include social and economic challenges such as hunger and poverty, education, environmental protection of land and oceans, climate change, sustainable cities, justice and equality[1]. In recent years, Goal 13 on climate change has attracted much international focus and gained much prominence through the subsequent Paris Agreement signed in 2018 and the 2019 UN Climate Action Summit.

2. Undertaking such large scale tasks inevitably requires very substantial funding. In its World Investment Report 2014, UNCTAD noted that achieving the SDGs will have very significant resource implications across the developed and developing world. It estimated global investment needs in the order of USD 5 trillion to USD 7 trillion per year. Estimates for investment needs in developing countries alone were seen as ranging from USD 3.3 trillion to USD 4.5 trillion per year.[2] It remains to be seen whether the dramatic impact of the ongoing Covid-19 pandemic will affect these targets, in view of the pandemic impact on government resources, and whether any revisions will need to be made as a result.

3. Both public and private sectors are expected to play vital roles through various domestic policy choices and targeted public capital spending. Since public funds are considered to be insufficient to meet the investment needs, the private sector contribution is indispensable. Thus the financial sector has a critical role to play in closing the investment gap. These developments have paved the way for the growth of what is termed today

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[1] https://sustainabledevelopment.un.org/?menu=1300
[2] Source: World Investment Report 2014, UNCTAD

'sustainable finance' with increasing funds flowing into this space over the past decade.

4. While it is recognised that increasing private investment in delivering the SDGs requires a global level of coordination through international bodies, domestic policymakers have a key role to play in facilitating the development of sustainable finance in their jurisdictions. This includes providing guiding principles to deal with various policy challenges arising in this field.

5. Specifically, the challenges include addressing issues such as common terminology (aka 'taxonomy'), transparency, disclosures and reporting related to the environmental, social and governance (**ESG**) aspects to prevent the phenomenon of 'greenwashing' and improving market data comparability on ESG matters through disclosure. In addition to building their own internal capacity in understanding this new area, financial regulators need to address concerns related to mitigating risks at supervised firms related to climate change or environmental risks, which may impact on the sustainability of financial firms and the soundness of the financial system at large.

6. The DFSA is actively involved in the developments related to sustainable finance in the UAE. We share and support the goals of the UAE leaders to strive to achieve the SDGs, which were expressed in, among others, the UAE 2021 Vision National Agenda, the UAE Green Agenda 2015-2030,[3] the National Climate Change Plan 2017-2050, the Dubai Declaration on Sustainable Finance[4] (2016) and the Abu Dhabi Declaration (2019), as well as through the ratification of the Paris Agreement in 2016.

7. Alongside other UAE and Free Zone regulators, UAE ministries and other bodies, we are contributing to developing sustainable finance by participating in a UAE Working Group on Sustainable Finance (**the UAE Working Group**)[5], set up in 2019, which published the UAE Guiding Principles on Sustainable Finance (**the UAE Guiding Principles**)[6]. The DFSA's CEO Bryan Stirewalt signed the UAE Guiding Principles at an official ceremony in January 2020. We also closely follow the work of the Dubai Sustainable Finance Working Group, launched jointly by the DIFC and the Dubai Financial Market, in which our regulated firms such as HSBC Middle East, Société Générale and Nasdaq Dubai actively participate alongside other financial industry participants and flagship Dubai corporates and bodies[7].

8. In the international arena, we actively contribute to work on various publications and standards development on sustainable finance. We do this through our participation in various international organisations such as the Basel Committee on Banking Supervision (**BCBS**), the International Organization of Securities Commissions (**IOSCO**) and the International Association of Insurance Supervisors (**IAIS**). In particular, as members of the Network for Greening the Financial System (**NGFS**) and the Sustainable Insurance Forum

[3] The UAE Green Agenda aims to establish the UAE as a sustainable global hub. It sets five strategic objectives and specific financial and economic goals, outlined within the Agenda's Green Finance and Investment Support Scheme that aims to stimulate the financial sector towards investment in green projects and green financial products and services, including sukuk.

[4] https://www.unepfi.org/news/dubai-declaration-on-sustainable-finance-announced-at-unep-fis-global-roundtable/

[5] http://dfsa.ae/MediaRelease/News/Leading-UAE-Authorities,-Financial-Exchanges-Form

[6] http://dfsa.ae/MediaRelease/News/The-DFSA-signs-Guiding-Principles-on-Sustainable-F

[7] https://www.difc.ae/newsroom/news/dfm-and-difc-launch-dubai-sustainable-finance-working-group/

(**SIF**), described in detail below, we help shape the debate and bring the regional perspective to the table.

9. This DP represents our current thinking on sustainable finance, inspired by the work of international bodies and standard setters and underpinned by the UAE leaders' goals and plans in this field. It has also been informed by our engagement with representatives of the financial industry in the DIFC and the Dubai Sustainable Finance Working Group, in which the DIFC Authority participates. Finally, this DP also represents a step forward towards our fulfilment of the commitments set out in the UAE Guiding Principles.

Part 1 First things first – Sustainable finance taxonomy

10. Sustainable finance is defined as the incorporation of environmental, social and corporate governance (**ESG**) aspects and considerations into all aspects of business operations, i.e., business decisions, risk management and investment strategies. The scope of ESG considerations is very wide and all three ESG components are perceived to be integral parts of sustainable economic development and finance. Broadly speaking, the ESG aspects can be thought to involve the following aspects[8]:

Key Pillars	Key Themes	Key Issues	
Environment	Climate change	Carbon footprint	Vulnerabilities from climate change events
	Natural resources	Energy efficiency Sourcing of raw materials	Water efficiency Usage of land
	Pollution and waste	Toxic emissions Wastewater management Hazardous materials management	Air quality Electronic waste management
	Opportunities and policy	Renewable energy Clean technology	Green buildings Environmental and biodiversity targets and investment
Social	Human capital	Workplace health and safety Development opportunities	Employee engagement, diversity, and inclusion Labor practices (e.g., wages, working conditions)
	Product responsibility	Product safety and quality Selling practices and product labeling	Customer privacy and data security Access to products
	Relations	Community Government	Civil society
Governance	Corporate governance	Board structure and accountability Accounting and disclosure practices	Executive compensation and management effectiveness Ownership and shareholder rights
	Corporate behavior	Management of corruption Systemic risk management Earnings quality	Competitive behavior Management of business environment (e.g., legal, regulations) Transparency on tax and related-party transactions

11. There is a noticeable diversity and plurality of taxonomies and terminologies used, often loosely and interchangeably, to describe opportunities, actions, products or investments offered in the field of sustainable finance. These are, for example, named as ‘climate’, ‘green’, ‘blue’, ‘sustainable’, ‘impact’, ‘social’, ‘responsible’, ‘socially responsible’ or ‘ESG’.

12. For now, there is no established consensus among the international policymakers, domestic regulators or the private sector as to the consistent use of these terms, which makes it difficult for both the public authorities and the industry to operate. This, inevitably, leads to free interpretation and increases the risk of mischaracterisation (the so-called ‘greenwashing’) of products or investments passing them off as something that they are not. For example, this may be manifested in either the described purpose or the way a product operates during its tenor and how the operator ensures monies flows where promised.

[8] Source: IMF Global Financial Stability Report October 2019 https://www.imf.org/en/Publications/GFSR/Issues/2019/10/01/global-financial-stability-report-october-2019#Chapter6

13. It is acknowledged that developing a comprehensive and consistent taxonomy, or in other words a classification system, is a very complex and technical challenge. Various public and private initiatives to address this subject have emerged. A wide divergence in terms of depth, terminology, methodology, parameters and key performance indicators can be noted. Some cover, albeit at high level, the entire ESG spectrum, such as the ICMA Sustainable Finance High Level Definitions[9] and standards. Others focus primarily on environmental protection and climate change, e.g., the EU Sustainable Finance Taxonomy[10], although certain elements of social aspects are also incorporated, or more narrowly on environmental protection, not addressing climate change (e.g. the Chinese Green Definitions[11]) or on climate change only (e.g., the Climate Bonds Taxonomy[12] and the Financial Stability Board's Task Force on Climate-related Financial Disclosures (**FSB**, **TCFD**)).

14. It goes without saying that, ideally, the taxonomy should provide for a uniform classification system, which is acceptable and usable worldwide, to reflect the international structure of the financial markets. This, however, may prove to be very challenging to achieve given the regional economic disparities and divergent priorities. In this DP, we will use the term 'sustainable' to describe a wide spectrum of instruments, or 'green' and 'climate' when it is appropriate in the context.

Questions for discussion:

1. **Do you have any comments regarding taxonomy based on, for example, the standards your firm uses, intends to use or have seen used?**

2. **Do you anticipate that any of the taxonomies described in Part 1, or any others still under development, may take the lead in the future?**

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9 https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/Sustainable-Finance-High-Level-Definitions-May-2020-110520v4.pdf. Prior to that securities issuers also relied on recommendations of the ICMA green, social and sustainability bond principles.

10 The EU Taxonomy Regulation is in the final stages of the EU legislative process. It will apply from end 2022.

11 https://www.climatebonds.net/resources/reports/comparing-china%E2%80%99s-green-definitions-eu-sustainable-finance-taxonomy-part-1

12 https://www.climatebonds.net/standard/taxonomy

Part 2 Sustainable finance - International landscape and developments

15. In recent years, the drive to achieve the SDGs through the operation and development of sustainable finance and reference to ESGs has triggered an unprecedented response from international and domestic public authorities, the financial industry, corporations and the not-for-profit sector. It is fair to say that the financial industry has been at the forefront of these developments, driven by increased customer demand. Along the same lines, some of the DIFC firms have been involved in this work, while some are considering joining one of a multitude of more or less formal associations and networks created to this end.

16. While much work has been done, by organisations such as the FSB/TCFD and IOSCO, into developing standards related to disclosure of the ESG aspects for the benefit of the financial community, it is clear that this may also be a source of financial risk to financial (and other) firms, which may impact on financial stability. As a result, the focus of bodies such as the NGFS, the IAIS, the SIF and BCBS has been on developing supervisory standards related to identifying, measuring and finding ways to mitigate these risks, in particular, as regards the environmental and climate aspects.

17. Several domestic financial regulators in various countries, including in Canada, China, France, Hong Kong, Malaysia, the Netherlands, Singapore and the UK to name just a few, have also considered this topic and taken various initiatives. Due to the number of these initiatives, and the variety of approaches taken, we do not cover them in this paper. However, the relevant frameworks in these jurisdictions do form part of our benchmarking process, which in the area of sustainable finance is all the more important.

2A International organisations

18. Various UN agencies such as the United Nations Environmental Programme (**UNEP**)[13], are driving the efforts towards raising awareness and building a financial system that supports SDGs through garnering support of signatories to a wide range of initiatives of a voluntary character. Several of them set out below are of particular relevance, given the DFSA and the DIFC regulated community support for these initiatives:

[13] Web links to the initiatives set out below are: https://www.unpri.org/; https://www.unepfi.org/banking/bankingprinciples/; https://www.unepfi.org/psi/the-principles/;

The Principles for Responsible Investment (PRI), launched in 2006, has over the years contributed to raising awareness of the ESG matters worldwide, with over three thousand asset managers, asset owners and service providers now being signatories to the PRI, including the DIFC's Hawkamah Institute. Many DIFC firms are also signatories through their head offices.

The launch of the Principles for Responsible Banking (PRB) in 2019, with 132 signatory banks, including many banks operating in the DIFC, provides the banking industry with a framework that aims to encourage embedding sustainability at the strategic, portfolio and transactional levels and across all business areas in line with the SDGs and the Paris Agreement.

The Principles for Sustainable Insurance (PSI), published in 2012, gained a large number of adherents and supporters from the insurance industry, included many operating in the DIFC, committed to following the sustainability principles in their business activities.

Connected to the PSI is the SIF, also operating under the UNEP as a network of more than 30 insurance supervisors and regulators from around the world working together, and in partnership with the IAIS and the NGFS, on sustainability challenges facing the insurance sector. The DFSA has recently joined the SIF, which will help us in building capacity and expertise in this field alongside other insurance regulators.

19. Other initiatives include the Sustainable Banking Network set up by the World Bank and the International Finance Corporation,[14] which has its MENA office in the DIFC, which engages over 45 emerging market financial regulators and bank associations accounting for over 85% of emerging market assets, as well as the OECD's Centre on Green Finance and Investment, which helps to develop policies, institutions and instruments in this field.[15]

2B International standard setters

20. By now, nearly all existing international standard setters for the financial industry are working on identifying issues and operationalising their approach to sustainable finance. In recent years, new international bodies have emerged, as 'coalitions of the willing' with a growing number of adherents. They have published reports on topical issues, recommendations and guidelines, which can be adopted on a voluntary basis. Depending on the subject, some overlaps or complementarity of the emerging standards can be observed, which is being increasingly remedied as clearer courses of action, partnerships and co-ordination among standard setters emerge.

21. It can be anticipated that, once a critical mass is reached in terms of voluntary adoption of these standards in both developed economies and emerging markets, certain standards

[14] https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/company-resources/sustainable-finance/sbn

[15] https://www.oecd.org/cgfi/about/

will take the lead in the regulatory community and the financial industry worldwide. This is certainly desirable given the global reach of the SDG agenda. While some 'leaders' can already be seen emerging, it may also be too early to tell.

22. For the purpose of this DP, the work of several standard setting bodies and organisations has been influential on our thinking. The DFSA engages with most, if not all, of these bodies. It is noteworthy that while some (namely IOSCO and the IFSB[16]) aim to cover the entire ESG spectrum, other bodies focus primarily on climate-related and environmental aspects.

Wide ESG scope

23. In the securities and markets space, IOSCO[17] has published recommendations encouraging voluntary disclosures of ESG related matters by issuers with a view to assisting investors in making more informed investment decisions.[18] Based on its members' recent survey, IOSCO intends to intensify efforts to encourage the disclosures by issuers and asset managers. This work will be supported by case studies, but it is still at its outset.

24. The IOSCO Growth and Emerging Markets Committee (GEMC), of which the DFSA is a member, and which is chaired by the UAE Securities and Commodities Authority, published a more detailed paper on the role of securities regulators in the field of sustainable finance in emerging markets.[19] The paper makes ten recommendations to regulators related to ESG-specific aspects to be considered when issuing regulations. Specifically, the recommendations cover:

(a) Integrating ESG-specific considerations in risk assessments and governance as well as investment and business decisions of issuers and institutional investors;

(b) Ensuring appropriate disclosure and reporting as well as good data quality; and

(c) For instruments labelled as 'sustainable': the definitions and eligibility criteria should be clearly stated; initial (i.e., offering) and ongoing ESG disclosures made; and third party reviews are encouraged including monitoring of proper use of funds.

Climate-related risks

25. Under the auspices of the FSB, the regulatory oversight arm of the G20 economies created in the wake of the 2008/9 financial crisis, the TCFD produced Recommendations[20] that address climate-related risk in many sectors of the economy, including financial services. The Recommendations provide for a voluntary disclosure framework that aims to improve the production and use of climate related financial disclosures. They apply across both

[16] For Islamic financial services, the **IFSB** encourages appropriate ESG disclosures and incorporation of climate change risks in the Islamic financial institutions operations. Although no specific guidelines or standards specific to the Islamic financial industry have emerged, disclosures on sustainability are expected from Islamic banks (IFSB-22) and takaful companies (ED-25).

[17] IOSCO operates the Sustainable Finance Network and the Task Force on Sustainable Finance to serve as an in-depth discussion platform on sustainability-related issues.

[18] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD619.pdf

[19] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD630.pdf

[20] https://www.fsb-tcfd.org/publications/

financial and non-financial sectors on the basis that the disclosures are important for all participants in the economy and financial markets, including issuers, investors, lenders and insurers, as well as their regulators.

26. The Recommendations are structured around four areas representing core elements of how organisations operate, which in turn recommend specific disclosures for each area as per the chart below.[21] They are accompanied by implementing guidelines, scenario analysis tools and bespoke guidelines for financial industries, specifically for banks, insurance, asset managers and asset owners, as well as for non-financial industries vital in the area of climate change such as energy, transport, construction and agriculture.

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organization's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.	Disclose how the organization identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

27. In the insurance sector, the **SIF** and the **IAIS** have published jointly two papers in the field of climate change: *Issues Paper on Climate Change Risks to the Insurance Sector* (2018) and more recently, in February 2020*, Issues Paper on the implementation of the TCFD Recommendations.*

28. The first paper identified the climate related risks which affect insurers worldwide (e.g., physical, transition and liability) and described how insurers tend to address them and how insurance supervisors approach these risks through their supervisory practices. The second paper focuses on disclosures made by the insurance industry against the benchmark of the TCFD Recommendations. It concluded that few insurers were actively implementing these disclosure standards, while at the same time supervisors differed widely in their approaches to addressing climate-related risks.

29. Since the issues papers do not create binding supervisory expectations on how supervisors, such as the DFSA, should implement the IAIS supervisory material, the IAIS and the FSI are planning to follow up with an application paper to set out best practice in how climate-related risk can be addressed through supervisory practices under the IAIS standards and disclosures in line with the TCFD.

30. For the banking industry, the **NGFS** has since 2018 been working on raising awareness and developing best practice guidelines to assist bank (and insurance) supervisors in developing a streamlined approach to addressing climate-change risk in their regulated firms.[22] It operates as a 'coalition of the willing' bringing together over 65 central banks and

[21] https://www.tcfdhub.org/recommendations/

[22] It also 'leads by example' by steering central bank pension fund investments into 'green' assets.

supervisors (including ourselves) as well as 12 international organisations and standard setters as observers.[23]

31. This year, the NGFS published a number of technical papers as a result of the work of three NGFS work streams, in which the DFSA participated as part of work stream 1. The documents provide for a framework comprising tools and methodologies to identify, quantify and mitigate climate risks in regulated firms and the financial system at large including risk differentiation between 'green' and 'brown' assets as well as guidelines on scenario-based climate risk analysis and transition scenarios. Other papers analyse macroprudential and financial stability impacts of climate change and relationship between climate and monetary policy. Going forward, a few other papers are expected focussing on metrics and data needs for the purpose of climate and environment related risks assessment. The full list of publications is set out below:

NGFS papers published in 2020
Guide for Supervisors: integrating climate-related and environmental risks into prudential supervision[24]
Status report on financial institutions' practices with respect to risk differential between green, non-green and brown financial assets and a potential risk differential[25]
NGFS climate scenarios for central banks and supervisors[26]
Guide to climate scenario analysis for central banks and supervisors[27]
The macroeconomic and financial stability impacts of climate change: Research priorities[28]
Climate change and monetary policy: initial takeaways[29]

32. Lastly, it is worth mentioning the **Basel Committee's** stocktake[30] publication on the actions and measures of its members in the field of climate change risk mitigation, to which the DFSA also contributed, which provides for a valuable comparative perspective on how this topic is approached by other supervisors. The Basel Committee also created a High Level

23 The Basel Committee, the IAIS, the SIF, IOSCO, the World Bank and the IMF
24 https://www.ngfs.net/en/guide-supervisors-integrating-climate-related-and-environmental-risks-prudential-supervision
25 https://www.ngfs.net/en/status-report-financial-institutions-practices-respect-risk-differential-between-green-non-green-and
26 https://www.ngfs.net/en/ngfs-climate-scenarios-central-banks-and-supervisors
27 https://www.ngfs.net/en/guide-climate-scenario-analysis-central-banks-and-supervisors
28 https://www.ngfs.net/en/macroeconomic-and-financial-stability-impacts-climate-change-research-priorities
29 https://www.ngfs.net/en/climate-change-and-monetary-policy-initial-takeaways
30 https://www.bis.org/press/p200430.htm

Task Force on Climate Risks as a forum to discuss supervisory matters related to climate risk.

Questions for discussion:

3. What is your view of the role the DFSA should adopt in the area of sustainable finance, including what the scope of any DFSA work should be (e.g., the entire ESG spectrum or only parts of it)??

4. In what way can our actions best contribute to the development of good practices and good regulation of this area?

5. Please provide some feedback if you have any experience with using or referring to any of the standards cited above?

6. Do you see any of these standards emerging as leaders in the future?

2C European Union

33. Currently in a vast majority of jurisdictions the regulators take a facilitative role, refraining from mandatory rules regarding sustainable finance. This is not the case in the European Union where several of the emerging standards are likely to be given binding character in the context of the implementation of the Action Plan on Sustainable Finance.[31]

34. We have considered the recent legislative measures and publications by the EU bodies, developed with the assistance of the primarily industry-led High Level Expert Group (HLEG),[32] which are expected to become effective in the EU over the next two years.

35. The *Regulation on **sustainability-related disclosures in the financial services sector*** enhances the existing EU framework on disclosures to investors in relation to sustainability. It imposes requirements on financial market participants[33] and financial advisers[34] in relation to financial products (e.g., funds). Specific requirements include pre-contractual disclosures, disclosures on websites and disclosures in periodic reports in relation to financial products. Other requirements include: (1) integration of sustainability risks in financial market participants' investment decision-making processes or, where relevant, advisory processes, and (2) transparency as regards financial products, which target sustainable investments, including reduction in carbon emissions.

31 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en#implementing

32 https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en

33 E.g. Alternative Investment Fund Managers under the AIFM Directive and the UCIT management companies and investment firms carrying out portfolio management.

34 I.e. firms authorised under the Markets in Financial Instruments Directive (MiFID) to give investment advice and credit institutions.

36. The EU Regulation on the *Establishment of a Framework to Facilitate Sustainable Investment* (the so-called "**Taxonomy Regulation**"), which provides for an EU-wide classification system intended to assist firms and investors with a common framework for identifying to what degree economic activities can be considered as "environmentally sustainable". The Taxonomy Regulation also covers several other minimum 'social and governance standards' in areas related to 'sustainability' such as respect for human rights, fair work relations (under the International Labour Organisation's treaties) or anti-bribery.

37. The Taxonomy Regulation is intended to apply to financial market participants (such as pension funds, insurers and asset managers) offering financial products (e.g., funds or pension products) and financial and non-financial firms reporting under the EU Non-Financial Reporting Directive (NFRD). Together with the rules on disclosure, it will require firms to disclose the degree of environmental sustainability of mainstream funds and pension products that are promoted as environmentally friendly, or to include disclaimers where they do not. In addition, the Taxonomy Regulation applies to domestic member states standards or labels for financial products or corporate bonds labelled as environmentally sustainable.

38. Proposal to create an ***EU Green Bond Standard*** (**EU GBS**),[35] linked to the Taxonomy Regulation to assess the sustainable profile of the bond offering. The EU has not yet decided whether the EU GBS will be a mandatory standard or whether to allow the industry to use it on a voluntary basis, as proposed by the HLEG and the Technical Expert Group (TEG). Either way, owing to the reference to the Taxonomy Regulation, the EU GBS is likely to have a significant impact on non-EU issuers, projects and verifiers, including those from the DIFC or the UAE, wishing to access the EU market.

39. Regulation amending the EU Benchmark Regulation (**BMR**) as regards ***EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks*** *and sustainability-related disclosure for benchmarks*. In addition to introducing the new climate benchmarks and mandated sustainability-related disclosures, the new rules bring changes to the BMR provisions on third-country benchmarks.

Questions for discussion:

7. Do you expect that the EU legislation in this field will affect your business in or out of the DIFC and, if so, to what extent?

8. Bearing in mind that some of the EU standards, such as the Taxonomy or the EU GBS are or may become mandatory, do you think that the DFSA should take them into account when considering our sustainable finance initiatives?

35 More information at: https://ec.europa.eu/info/publications/sustainable-finance-teg-green-bond-standard_en

2D Industry-driven initiatives

40. A large number of industry-led voluntary initiatives relating to sustainable instruments and activities also need to be mentioned, due to their international reach and potential industry adoption. Various bodies and associations have issued voluntary standards, which concentrate primarily in the area of green and sustainable bonds and disclosure and reporting by corporates and issuers. Many readers would be familiar with these initiatives, some of which have won significant industry recognition. Just a handful are listed below, for the sake of example, but many more can be found in this space:

    (a) the Green Bond Principles and the Sustainable Bond Principles issued by the International Capital Markets Association (ICMA);

    (b) the Climate Bonds Standards and Certification Scheme by the Climate Bonds Initiative (CBI);

    (c) the Green and Sustainable Bond Standards by the ASEAN;

    (d) the Global Reporting Initiative (GRI); and

    (e) the Green Loan Principles (GLP) issued by the Loan Market Association (LMA).

Questions for discussion:

9. Should the DFSA consider any of the industry standards for the purpose of our thinking on sustainable finance? If so, what should our role be given that these standards are voluntary?

10. Do you see any of these standards becoming sufficiently prevalent and ingrained so as to render regulatory intervention unnecessary?

2E UAE developments

41. As mentioned before, in the past few years the UAE leadership has actively promoted and supported sustainable finance strongly underpinned by sustainable industry initiatives. The UAE has come a long way in meeting the challenges of energy and climate change, under the framework of the 2021 Vision National Agenda and the strategic plans of each emirate. It has thus built the enablers contributing towards the achievement of the SDGs. In this context, the UAE committed, for example, more than USD 840 million (AED 3.1 billion) to renewable energy in more than 30 countries[36].

[36] https://u.ae/en/information-and-services/environment-and-energy/environmental-protection/efforts-towards-sustainability

42. These developments motivated the creation of the **UAE Working Group** associating the UAE financial regulators (e.g. the UAE Central Bank, the Securities and Commodities Authority, the Insurance Authority, the Financial Services Regulatory Authority of ADGM and the DFSA), the Ministry of Climate Change and Environment, several UAE exchanges (including Dubai Financial Market, Nasdaq Dubai and Abu Dhabi Securities Exchange) and other bodies such as the Dubai Islamic Economy Development Centre. The UAE Working Group, which collaborates with the UAE National Committee on SDGs to ensure alignment with the UAE's priorities set out in the 2030 Agenda, serves as a platform to discuss and further the SDGs through the financial industry.

43. In January 2020, following industry consultation, the UAE Working Group published the **UAE Guiding Principles,** which are underpinned by individual initiatives of its constituents and constitute a declaration of a joint commitment of the signatories on the minimum elements of a sustainable finance framework in line with prevailing international recommendations and standards (as described in the preceding sections). The document comprises three principles addressing the following areas:

    I. **Integrating ESG factors to governance, strategy and risk management by financial firms**

    II. **Minimum eligibility requirements for a product to be labelled sustainable; and**

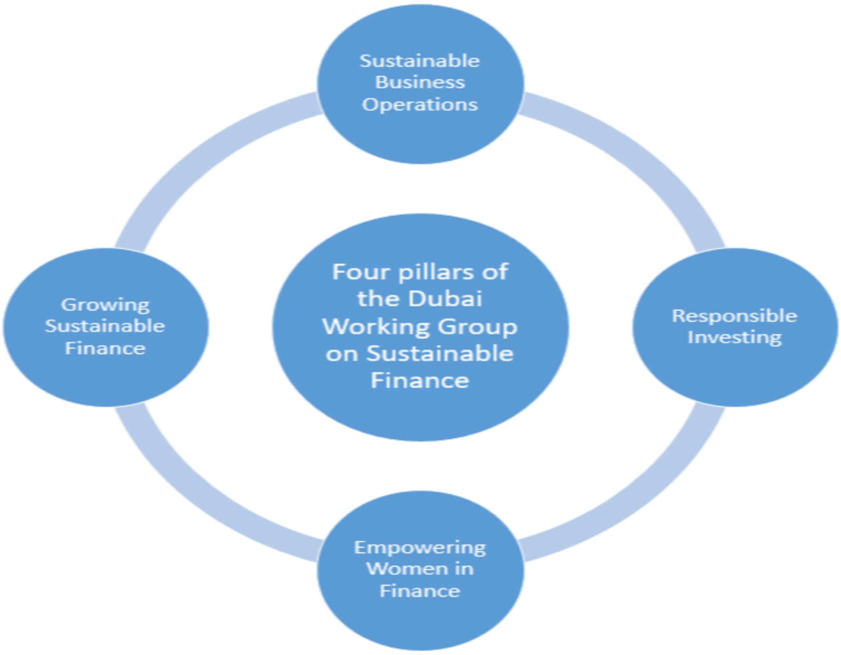
    III. **Promoting appropriate ESG-related reporting and disclosures**

44. In addition, DFSA-regulated firms, such as HSBC, Société Générale, Zurich and Nasdaq Dubai, alongside the Hawkamah Institute for Corporate Governance, Dubai Financial Market, Dubai Islamic Bank, Dubai Islamic Economy Development Centre, Emirates NBD, ENOC, Majid Al Futtaim, Aramex, DP World and DEWA created, in July 2019, the **Dubai Working Group on Sustainable Finance** with a goal to spearhead these developments[37]. The Group aims to foster embedding ESG aspects into the Dubai financial sector, mainstreaming ESG risk analysis and identifying business opportunities for innovation.

45. To achieve this, the group, which is issuing a number of publications, for example 'A Guide to Sustainable Finance'[38], with more publications forthcoming including guides on sustainable issuances and sustainable investments, is focussing its work on four key pillars:

[37] https://www.difc.ae/newsroom/news/dfm-and-difc-launch-dubai-sustainable-finance-working-group/

[38] *A Guide to Sustainable Finance*



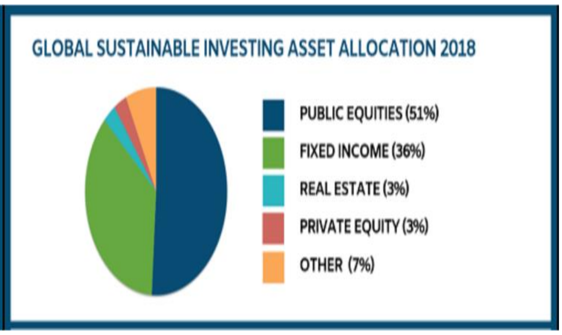
46. Another initiative worth mentioning is that of the **Clean Energy Business Council (CEBC),** which aims to facilitate dialogue between the public authorities and private sector in the renewable energy space in the MENA region to drive the development of appropriate regulation and policy to support the development of the sector vital to the achievement of the SDGs. CEBC contributes to furthering these goals and raising awareness through its numerous publications, programmes, events, case studies, data collection and active member network.

Questions for discussion:

11. What is the most effective way for the DFSA to co-operate with other UAE authorities towards the development of sustainable finance in the DIFC and the UAE?

Part 3 Direction of travel on sustainable finance in the DIFC

47. Sustainability has become a significant driver of fund flows with the largest investments tripling over the last decade in Europe, followed closely by USA, from nearly no funds allocated to this area in early 1990s. As per the charts below, the assets are allocated to a large extent to public equities and fixed income instruments but other important fund flows benefit real estate, private equity and other sectors including funds.[39] As far as fund flows into ESG-oriented funds alone, these have grown by 40% to EUR 684 billion between 2014 and 2018 in Europe.[40]



48. With such significant growth, the ability to understand and manage the sustainability-related issues relies heavily on good and consistent standards as well as transparency and disclosure of the economic and market participants in relation to sustainability issues.

49. Considering these developments and the emerging recommendations from various standard setters, a question arises as to what extent and at what speed the DFSA should take a more active role in facilitating the development of sustainable finance in the DIFC in line with our regulatory objectives. It is the optimal type and scope for our actions that we seek to explore through this DP.

50. The current plurality of strands pursued by the international standard setters makes it somewhat challenging to determine the desired direction of travel for the DFSA, which would most benefit the DIFC community, Dubai and the UAE. Bearing in mind that many of the standards discussed above are not yet final and given limited practical supervisory experience, it is accepted that if we were to provide guidance or legislate in some areas, our actions would need to be gradual and measured.

51. We are also mindful of the fact that given the DIFC's profile, which to a large extent contributes to connecting multiple providers and users of financial services worldwide, the effects of our initiatives on sustainable finance would benefit parties outside our perimeter, so contributing to the achievement of the SDGs overall in the UAE and beyond. For this reason, taking account of the international character of sustainable finance, we would like to strive to achieve balanced and optimal results through our target actions.

52. Lastly, it is noteworthy that the matters discussed below apply in equal measure to conventional and Islamic financial institutions and products, based on the premise that the

39 Source: Global Sustainable Investment Alliance

40 Source: The Evolving Approaches to Regulating ESG Investing Morningstar, 2019.

universal character of the ESG aspects does not impact on the Shari'ah considerations. Indeed, the focus of Islamic finance on the real economy and underlying productive activity is, in many ways, a natural fit with the sustainable finance agenda,

3A DIFC Green Hub

53. We recognise that for some DIFC firms the topic of sustainability will not be all that familiar, and that they may have little to no experience in dealing with the ESG aspects in practice. Most, if not all, regulators and supervisors grapple with the same issues. It follows, therefore, that capacity building, awareness raising and knowledge sharing are important elements of developing best practices by both regulators and the financial industry.

54. With this in mind, we would like to see any actions described in this DP accompanied by multilateral dialogue on sustainable finance in the DIFC. One way of doing this could be creating a DIFC Green Hub to operate as a public-private network of stakeholders interested in capacity building, exchange of information and knowledge sharing, discussing questions and challenges under the Chatham House Rule.

55. Where beneficial, the Hub could organise relevant events, invite input from academia, researchers and other bodies active in the sustainability field in the DIFC, UAE or beyond. The DFSA could offer to act as a secretariat and provide a co-coordinator role and host meetings and events. Other initiatives could be further developed akin to, for example, those in the innovation space, where the DIFC and Dubai have taken the lead in creating an ecosystem for innovation in financial services. Going forward, links with similar networks in other parts of the region and the world could be established to harness the benefits of the Hub.

Questions for discussion:

12. Do you support the idea of the creation of the DIFC Green Hub and, if so, do you have any other comments or suggestions as to its objectives, operation and activities?

3B DIFC securities markets

Debt

56. In 2018, in response to the growing market demand and based on stakeholder consultation, we published the Green Bond Best Practice Guidelines[41] based on the voluntary ICMA Green Bond Principles. The Guidelines paved the way for successful issuances of green instruments now listed on Nasdaq Dubai, including the first sovereign green sukuk by the Government of Indonesia totalling USD 2 billion[42] and the first corporate benchmark green

41 Markets Brief 18 - https://www.dfsa.ae/en/Your-Resources/Publications-Reports/Markets-Publication

42 https://www.difc.ae/newsroom/news/government-indonesia-celebrates-listing-two-green-sukuk-totalling-usd-2-

sukuk by Majid Al Futtaim Group of USD 600 million in the MENA region open to international investors[43].

57. The Guidelines clarify our expectations on primary market disclosures and continuing obligations for issuers of conventional bonds and Islamic bonds (sukuk) seeking to fund ESG related projects and assets. By disclosing the information about the use of the proceeds for ESG purposes and tracking the net proceeds on the basis of the issuer's voluntary disclosures, the expectation is that 'greenwashing' can be minimised.

58. Based on our observations, as the size of, and interest in, sustainable finance has grown rapidly across the globe, so has the number of private and public standards for sustainable instruments, in particular for sustainable and green bonds. In the absence of a common world-wide ESG taxonomy, the multiple sets of public and industry standards, while sharing some common features, may inevitably lead to duplication and unintentional conflict between the various initiatives, thus burdening the eligible issuers and potentially leading to confusion amongst investors.

59. The voluntary standards that a debt issuer can consider using, depending on the investor origin or preference or the guidelines at the place of issuance, include those mentioned in section 2D. Meanwhile, as already mentioned, the upcoming EU GBS is likely to become influential by reason of its connectedness with the EU Taxonomy Regulation (which is mandatory). The EU GBS draws upon the ICMA and the CBI standards, and has received extensive industry input.

60. As we have come to conclude that the DFSA Green Bond Best Practice Guidelines may be ripe for review, a series of options emerge in terms of which the available standards should be given weight. We consider that the choice should ultimately contribute to the development of this area and facilitate the issuance of sustainable instruments in and from the DIFC, while ensuring that the risk of misrepresentation and 'greenwashing' are substantially reduced. For this reason, we consider that at this stage the standard should continue being accessible on a voluntary basis.

61. Bearing in mind that whichever option we follow it should be compatible with the IOSCO recommendations in this field (discussed in paragraph 22), the potential options for the source for the DFSA Guidelines - on which we seek stakeholder views - include:

    (a) **Continuing drawing upon the ICMA standards**, which would allow us to provide more clarity into the definitional nuances and include other types of instruments such as Social and Sustainable Bonds Principles to complement the other areas of the ESG spectrum;

    (b) **Considering other standards**, such as the CBI Climate Bonds or the EU GBS. For example, following the latter would potentially allow expansion of the investor base for DIFC-issued bonds, particularly if the EU GBS becomes mandatory; or

billion-nasdaq-dubai/

43 https://www.difc.ae/newsroom/news/majid-al-futtaim-lists-worlds-first-benchmark-corporate-green-sukuk-nasdaq-dubai/

(c) **Allowing for a freedom of choice of standards**, provided they are sufficiently robust and recognised, and that certain minimum requirements are met. This would allow the issuers seeking to list in the DIFC to tap a wider array of opportunities by, for example, tailoring the issuance of various tranches under their issuance programmes to specific groups of investors.

62. On a different but related note, we would be interested in exploring views on the interest in and avenues to facilitate developing a sustainable smaller issue size bond market by unlisted SMEs to support ESG-related companies and projects. Typically, bond issuances tend to be sizeable, above USD 200 million, to be relevant for institutional investors. This constitutes a barrier for many medium-sized enterprises involved in ESG-related small-scale projects, which are prevalent in the sustainability sector. Examples of such bonds can be found in Italy and Germany and this topic has also been studied by the EU bodies.[44]

Questions for discussion:

13. Do you have any comments related to the options discussed in this section (3B)?

14. In your experience, which of the sustainable bond standards is likely to reflect your needs when seeking issuance in the DIFC?

15. What are your views on the opportunities and challenges related to developing a smaller issue size bond market for sustainable issuers or projects in the DIFC?

Equity

63. Under the DFSA's Markets Rules, issuers offering securities to the public or those intending to have their securities admitted to trading on an Authorised Market Institution must meet a range of disclosure requirements, both when securities are offered in or from the DIFC and on an ongoing basis upon admission to trading. The disclosure relates to, amongst other things, the assets and liabilities, financial position and prospects of the issuers.

64. The issuers of securities need to consider what disclosures should be made to adequately inform investors of the financial implications related to sustainability and the ESG aspects for their business, including what adjustment they may need to make to their business to manage risks or explore opportunities. The impact of these matters on an individual business will vary, and while some may be materially exposed to these risks and opportunities others may remain neutral. The time factor of the risks manifesting also needs to be considered. The specific circumstances of a particular issuer will determine the scope

[44] Study on the Potential of Green Bond Finance for Resource-Efficient Investments

and nature of the disclosures. Otherwise, there is a risk that an issuer that provides no adequate information on these issues will fall foul of the disclosure requirements.

65. While we note that some issuers in the DIFC have started providing disclosures on sustainability matters as part of their reporting,[45] we are cognisant of the fact that currently no specific guidance exists in the DIFC which would help issuers assess the risks facing their business and decide whether a materiality threshold is reached in a specific scenario. For this reason we are looking to explore whether guidance is needed or expected from the DFSA in this field. Other issues to explore are whether guidance in a streamlined format for disclosure would assist in achieving more comparability.

66. Importantly, to assist the DIFC issuers assess their climate-related risks we would encourage them to consult the TCFD Recommendations and consider how they could be used for the benefit of their business, investors and other stakeholders. The Recommendations address a range of relevant aspects such as materiality, internal governance, format and frequency of disclosures.

67. While noting that the TCFD Recommendations are intended to operate on a voluntary basis, given slow uptake, some regulators have explored whether they should be used on a 'comply or explain' basis.[46] Since we see the merits of this idea, we would be interested to hear whether such a 'complain or explain' approach would usefully contribute to stimulating the DIFC listed firms to increase their level of disclosure in relation to sustainability issues.

Questions for discussion:

16. Do you have any comments related to the issue of disclosure obligations in relation to sustainability?

3C Transparency and disclosure

68. While the sustainable finance universe has grown in size and complexity, there has been a noticeable lack of coordination and uniformity in terms of market transparency and disclosures. This inevitably impacts on investor ability to make informed decisions as the information may be crucial for investors' own risk management and ability to anticipate returns and build truly sustainable investment portfolios in line with client mandates.

69. In particular, if valuations do not adequately factor in climate-related risks because of insufficient information, this might lead to difficulties in identifying stranded assets and the risk of mispricing of longer-term investments, ultimately leading to large-scale losses. It is worth noting that the stakes are high as the diverse group of stakeholders, with trillions of

45 https://www.dpworld.com/-/media/Supporting-Documents/DP-World-Sustainable-Development-Financing-Framework-Second-Party-Opinion-PUBLISHED.ashx

46 https://www.fca.org.uk/publications/feedback-statements/fs19-6-climate-change-and-green-finance

US dollars under management, comprise entities such as asset managers, mutual funds, pension funds, insurance companies, and asset owners such as sovereign wealth funds.

70. In response to market demand, the FSB-mandated and industry-led TCFD presented, in 2017, a universally applicable voluntary set of recommendations on climate-related disclosures. The Recommendations contain disclosure standards for companies and issuers in a wide range of industries, including a dedicated subset of specific Recommendations applicable to banks, insurers, asset owners and asset managers:

    (a) while for banks the disclosures pertain primarily to the risks a bank carries in its books in relation to climate-vulnerable assets, the insurers' disclosures are effectively two-fold – relating to the risks of underwriting activities and to the investments risks of insurers as asset owners. This topic is discussed more in section 3D;

    (b) in relation to asset managers, the Recommendations specify the disclosures to be made to clients for whom product; investment strategy; or client-specific disclosures are relevant. This is because asset managers' clients rely on this type of reporting to understand how climate-related risks and opportunities are managed within each of their portfolios; and

    (c) disclosures by asset owners (e.g., pension funds, foundations, sovereign wealth funds) allow beneficiaries and other stakeholders to understand exposures to climate-related risks and opportunities. This may encourage better disclosures across the investment chain - from asset owners to asset managers to underlying companies - thus enabling better-informed investment decisions.

71. The DFSA is not aware of the current level of understanding of the TCFD Recommendations or the interest in following them among the authorised firms. Overall, as per the TCFD progress report in 2019, the uptake of the voluntary disclosures has been judged slow except for some notable examples, and remains insufficient to guide investor decisions in a meaningful way.

72. Through this DP, we encourage the authorised firms to consider the TCFD framework as it applies to their DIFC business and explore whether specific assistance is needed from the DFSA to accelerate the progress to meaningful disclosures. We recognise that in situations where Authorised Firms operate in the DIFC as branches, their ESG-related disclosures are likely to be done at the head office level for the group or sub-group.

73. Similarly to the approach for public equity, we are considering whether a 'comply or explain' approach could be warranted more broadly to authorised firms or whether another approach would be more useful. A 'comply or explain' approach appears to be consistent with the voluntary nature of the TCFD Recommendations.

74. As the TCFD recommendations remain voluntary, focus primarily on climate-related aspects and cover some but not all firms offering financial services, there may be a need to consider other complementary approaches such as those akin to those proposed in the EU and by some European regulators. As mentioned above, the EU have put in place

mandatory disclosure requirement for some financial market operators, which cover a wider range of ESG matters than only climate, and rely on the EU Taxonomy.[47]

75. While we do not consider that a mandatory route is advisable at this point in time, and it would not be consistent with the TCFD approach we propose in other areas, we could envisage introducing guidelines on a ‘comply or explain’ basis to cater for situations when, for example, a financial product or an investment is offered by an Authorised Firm and marketed as ‘sustainable’. The objective would be to require that the marketing is clear, fair and not misleading to counter the risk of ‘greenwashing’. At this point in time, we believe that the choice of taxonomy should be left to the market, provided it is recognised and representative.

76. For example, the guidelines, which could be termed an ESG Code, could provide for a number of conditions to be met when offering products to clients in and from the DIFC:

(a) appropriate, clear and meaningful disclosures should be made along the intermediation chain in relation to the ESG-related benefits in offering and ongoing client documentation;

(b) clear reference to the ESG standards and taxonomies relied on and how the product or investment meets them at the point of sale and throughout its tenor;

(c) if relevant, how the funds or their tranches will be used for the ESG-related objectives; and

(d) the conditions on the use of third party verifiers.

Questions for discussion:

17. Do you have any comments in relation to your firm’s ability to make the disclosures under the TCFD Recommendations?

18. Would the DFSA ‘comply or explain’ approach facilitate and foster your firm’s commitment towards using the TCFD Recommendations?

19. Would DFSA guidance on a ‘comply or explain’ basis in relation to ESG-labelled products foster customer confidence and reduce the risk of ‘greenwashing’, while not adversely affecting the development of this area?

3D Ancillary services – sustainability verification

77. There are some ancillary services which have developed in the sustainable finance sphere, which include ESG-related verification and ratings services, data analytics and research

[47] This is under the Non-Financial Reporting Regulation but also through recent changes to the rules on securities (MiFID II) and Funds (AIFMD and UCITS).

and ESG-related indices.[48] The participation of the external verifiers in the sustainability ecosystem has been recommended by the UN PRIs and supported by several sustainable and green bond principles (e.g., EU GBS, CBI and ICMA).

78. These developments are also a response to customer demand from, for example, issuers and sell-side firms as well as from asset and pension fund management industries. The issuers are particularly active customers of the rating and verification service providers for a whole range of ESG-related products.

79. The external ESG verifiers and ratings providers can be engaged either at the issuance stage or end-to-end, with a goal to ascertain whether a security or a financial product for which the funds are raised do indeed have specific 'sustainable' or 'green' benefits and that the funds will be used during its term to contribute to achieve the 'sustainable' goals.

80. While initiatives such as the TCFD disclosure recommendations contribute to increasing the availability of quality comparable information, the external verifiers, certification bodies and 'sustainable' ratings providers have an important role to play. As evidence shows that sustainable-labelled instruments can increasingly attract higher level of customer interest and premiums at issuance, verification and ratings become all the more crucial element of securities and other product offerings. It can be expected that these entities will play increasingly important roles as sustainable finance gains more ground.

81. In the absence of a uniform world-wide 'sustainability' taxonomy, which would facilitate objective comparisons, the service providers tend to diverge in terms of the taxonomies followed and the methodologies used, with some using proprietary taxonomies and standards, while others tend to refer to a select range of third party standards. In some instances, due to cost implications, the certification is provided only at the point of issuance, while for the remainder of the tenor the disclosures by the issuers need to suffice. The methodologies and models used by the certification bodies are generally available publicly, albeit sometimes access may be restricted.

82. Given that a high degree of public reliance is placed on the verification process, a question arises whether these currently unregulated entities should come under some form of regulatory scrutiny. This would be to ensure that legitimate expectations as regards adequate quality, objectivity and reliability of the verification process, as well as the freedom from the conflicts of interest, are addressed. For example, the *Usability Guide* on the EU GBS, prepared by the industry-led Technical Experts Group, recommends in Chapter 7 a range of useful requirements in respect of such firms, which are expected to enhance confidence in the sustainable labelling services.

Questions for discussion:

20. Do you have any comments on issues related to the verification services or service providers?

[48] The existing credit rating agencies and the Big Four audit firms, as well as a wide range of other firms, are active in this space.

3E Banking and insurance – supervisory aspects

83. It is primarily the job of the financial industry firms to identify, assess and manage the risks present in their activities and it is for the supervisors to assess how well the firms do that. It goes without saying that sustainable finance creates opportunities for banks and insurers to develop new products, business lines and tap new markets. However, on the flip side it is also a potential source of risk, which the firms need to appropriately assess and address, and bank and insurance supervisors, in line with their mandates, need to supervise.

84. As discussed above, the climate-related and environmental risks (which have attracted most focus) represent a relatively new area for many supervisors. For this reason many of them have been working on increasing their supervisory capabilities in order to understand how these risks apply and transmit to banking and insurance businesses and, ultimately, how they could impact on the soundness of individual firms and on financial stability overall.

85. While certain supervisors have taken individual actions (see the recent BCBS stocktake of current supervisory initiatives[49]), much of the scoping, mapping and analytical work has taken place in the international standard setter fora, such as the SIF and the IAIS for insurance and the NGFS for banking and insurance. As previously mentioned, the TCFD Recommendations cover disclosures that should be made by banks and insurance companies in respect of the climate-related risks.

86. In general, to assist supervisors in addressing the risks, the standard setters advocate increased regulatory and supervisory scrutiny, which could be developed in a series of steps, involving close co-operation and dialogue between the supervisors and firms:

- **Step 1** - relevant climate-related and environmental risks are identified by firms and supervisors, followed by an analysis of transmission channels as sources of financial risks to the specific banks and insurers in the jurisdiction;

- **Step 2** - sourcing and providing adequate data and developing analytical and methodological frameworks and metrics are crucial as the next stage to conduct quantitative and qualitative risk assessment of potential exposures and vulnerabilities to these risks;

- **Step 3** - relevant stress scenario analysis and stress testing methodologies can then be developed at individual firms with a view to conducting stress testing; and

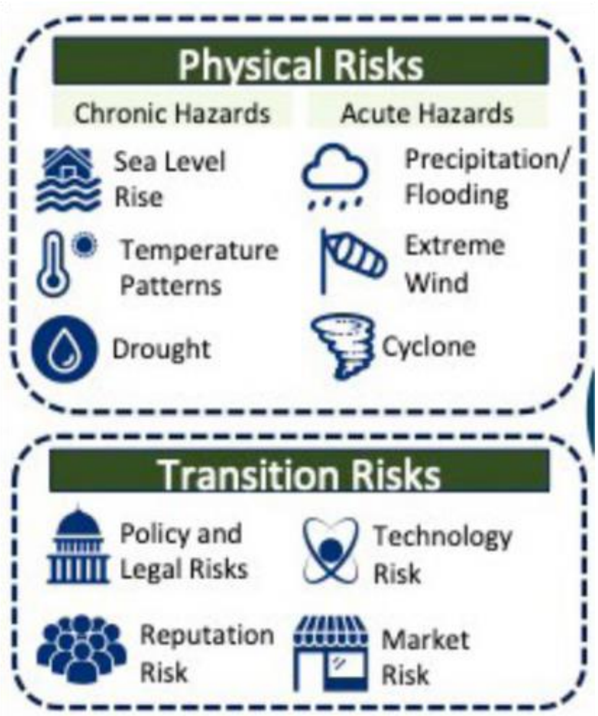
- **Step 4** - supervisory expectations are defined as to how the banks and insurers should respond to these risks, relying on the available mix of the usual supervisory tools and relevant risk mitigation methods available.

87. Regarding **Step 1**, various SIF/IAIS and the NGFS publications explore the types of climate-related and environmental risks. The risks fall into two broad categories, including physical and transition risks. While physical risks refer to the actual effects of various weather events as a result of climatic or environmental changes, transition risks refer to economic and financial impact of changes in national policies, consumer sentiment, market and

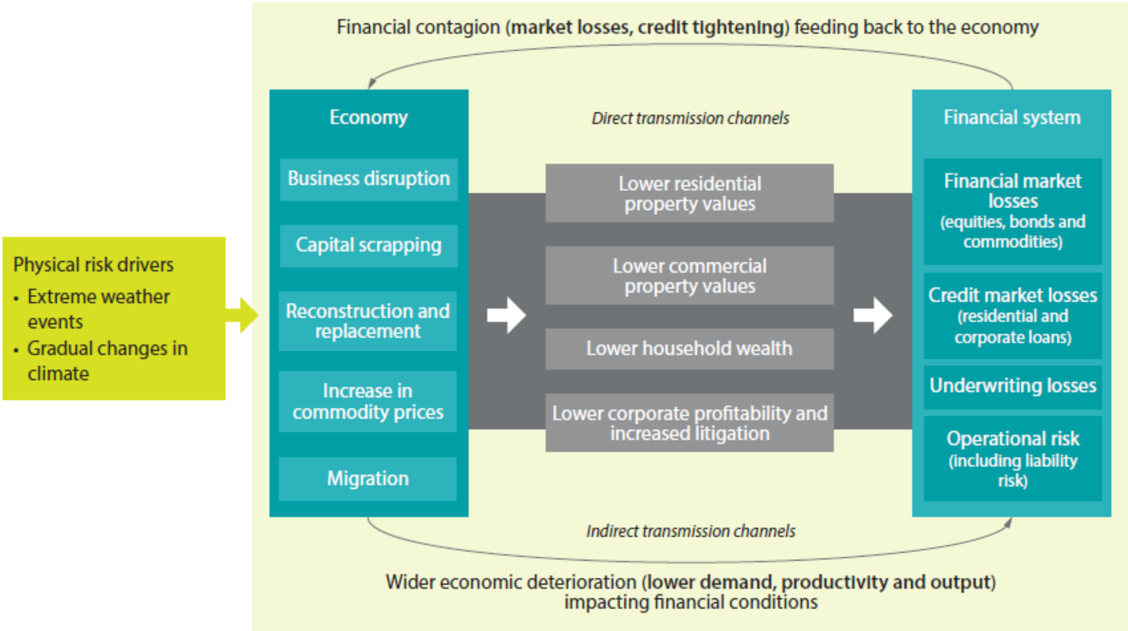
49 https://www.bis.org/bcbs/publ/d502.htm

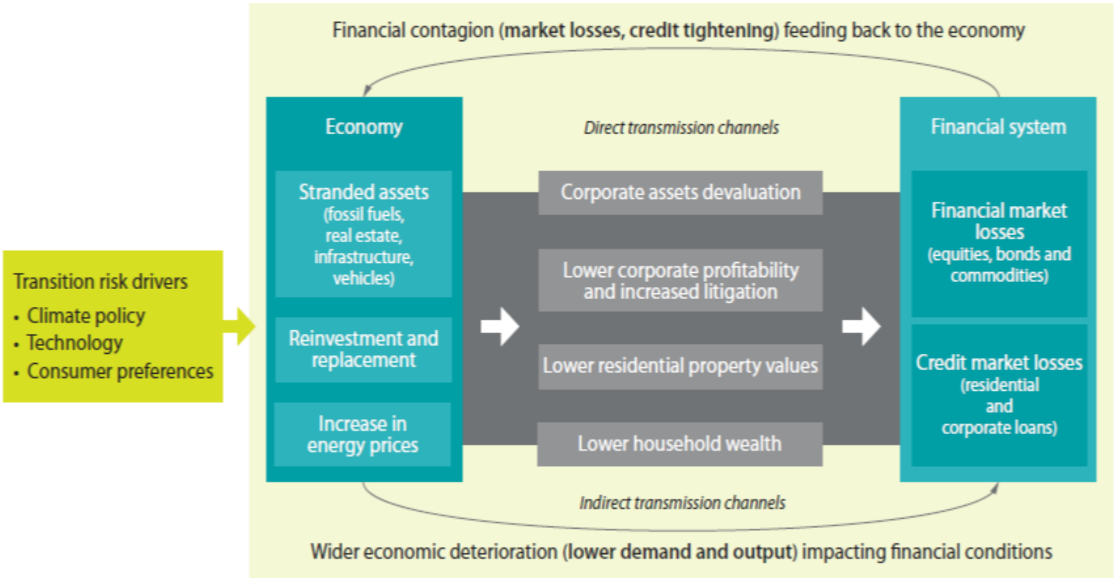
technological shifts resulting from more pro-active approaches to addressing climate and environmental risks. Legal and litigation risks, which fall under the transition risks, have been singled out as particularly significant.

88. In general, it is fair to say that while transition risks can be seen as more predictable and short-term, the physical risks are less predictable and observable in the longer run. For example, the 'greening' policy changes are expected to take place within the next decade, while the impact of climate change and rising temperatures may be increasingly evident in the next several decades. Examples of the risks can be depicted as follows:



89. Overall, a number of transmission channels to the financial system have been identified for physical and transition risk drivers respectively. This translates into heightened financial risks typically identified at banks and insurers, such as market, credit, operational, investment and underwriting risks (source: NGFS 2020):





90. Although not all climate-related and environmental factors can yet be mapped and their actual occurrence will be different depending on the geographic location of the supervised firms, the table below provides for some useful examples of impact on prudential risks at banks and insurers. Needless to say, both the actual factors and the corresponding transmission channels remain an area that is subject to ongoing scientific research while the impact of the future policy measures remains to be seen as and when they are implemented (source: NFGS 2020):

Prudential risk categories	Examples of climate-related factors affecting prudential risks
Credit risk	The destruction of a production site by wildfire can increase the probability of default of the company operating the site. Loss stemming from default of mortgage-backed loans can increase when the value of buildings provided as collateral decreases due to new energy-efficiency standards.
Operational risk	Extreme weather events can have an impact on financial institutions' business continuity through, for instance, damage affecting critical functions of the financial entity or of its main providers. Financial institutions or their customers might face a liability[1] charge from parties who have suffered losses from physical and transition effects and seek to recover these losses from those they view as responsible.
Market risk	Severe weather events or political measures regarding the transition could lead to re-pricing of financial instruments and corporate debt affecting the value of securities held on financial institutions' balance sheets (and/or the value of collateral used in some operations). The introduction of a carbon tax can result in investment losses and lower assets' values (stranded assets).
Underwriting risk	Extreme weather events such as floods in coastal areas may result in higher than expected insurance claim pay-outs in the case of damaged insured properties.
Liquidity risk	A lack of reliable and comparable information on climate-sensitive exposures of financial institutions could create uncertainty and cause procyclical market dynamics, including fire sales of carbon-intensive assets, and potentially also liquidity problems.

91. It is fair to say that **Steps 2 and 3** pose a number of challenges for both firms and supervisors. At the same time, several areas remain still under development at international level as they are, to some extent, related to the advancement of research on climate and environmental matters. The challenges are related to obtaining adequate data granularity at firms (e.g., in relation to climate/emissions), climate forecasting making it difficult to assess the time factor of risk, defining applicable taxonomies (brown/blue/green), time horizon misalignments between banks' prudential profiles and climate factors. Insufficient awareness and expertise both at supervisors and supervised firms also translates into practical difficulties in discussing these matters.

92. **Step 4** may involve a number of supervisory actions, starting from issuing supervisory guidelines or statements (e.g., the Dear SEO letters[50], as per the DFSA practice). These would outline the supervisory plans and expectations in this area and encourage firms to take actions to embed climate and environmental risks in their governance, integrate these risks within risk management, and address these risks in their business model and strategy. They may also emphasise the need to increase disclosure and/or reporting of climate-related and environmental exposures and financial risks, for example in line with the TCFD Recommendations.

93. The NGFS *Guide for Supervisors*[51] and the upcoming SIF and IAIS *Application Paper on climate change risks in the insurance sector* address the use of various supervisory tools that could be applied, including disclosure based on the TCFD standard. The DFSA will take them, and potential other examples from other regulators, into account in our

50 https://www.dfsa.ae/en/Your-Resources/Publications-Reports/SEO-Letters

51 https://www.ngfs.net/en/guide-supervisors-integrating-climate-related-and-environmental-risks-prudential-supervision

approach.[52]

94. We recognise that our supervisory approach in this area in respect of the DIFC banks and insurers, as per the steps set out above, will need to be appropriately adapted, and take into account the nature, scale and complexity of the firm's business in the DIFC. The profile of the majority of the DIFC firms, many of which operate as branches, or their limited activities or product ranges in or from the DIFC, means that the relevance of some of these considerations may be diminished.

95. In addition, we are also cognisant of the fact that financial risks from climate change will impact firms differently, depending on their DIFC business models and balance sheets particularities. Bank assets and liabilities may be affected by physical and transition risks depending on their geographic reach, manifesting in various ways such as through the impact on counterparties' operations, the viability of borrowers and changes to collateral values. Equally, certain insurance risks, such as underwriting risk, related to 'brown' projects may be more pronounced, while investment risks or retail life insurance would not be manifest in the DIFC insurance sector given the lack of such activities.

96. As the DFSA and the firms will build internal capacity in this field, we intend to commence a dialogue with the authorised firms on these topics. Through this we would like to encourage the firms to ensure that they undertake an exercise to assess the impact of these risks on existing risk types in their DIFC operations. As more guidance emerges on various aspects such as data inputs and metrics, taxonomies and stress testing scenarios, we will also be in a position to fine-tune our approach.

Questions for discussion:

21. Do you have any comments on the DFSA's plans to adapt our supervisory approach to address sustainable finance issues?

[52] We may also consider the UK PRA Policy Statement 11/19 on '*Enhancing banks' and insurers' approaches to managing the financial risks from climate change*'

Annex 1: Questions in this Discussion Paper

Questions:

1. **Do you have any comments regarding taxonomy based on, for example, the standards your firm uses, intends to use or have seen used?**

2. **Do you anticipate that any of the taxonomies described in Part 1, or any others still under development, may take the lead in the future?**

3. **What is your view of the role the DFSA should adopt in the area of sustainable finance, including what the scope of any DFSA work should be (e.g., the entire ESG spectrum or only parts of it)??**

4. **In what way can our actions best contribute to the development of good practices and good regulation of this area?**

5. **Please provide some feedback if you have any experience with using or referring to any of the standards cited above?**

6. **Do you see any of these standards emerging as leaders in the future?**

7. **Do you expect that the EU legislation in this field will affect your business in or out of the DIFC and, if so, to what extent?**

8. **Bearing in mind that some of the EU standards, such as the Taxonomy or the EU GBS are or may become mandatory, do you think that the DFSA should take them into account when considering our sustainable finance initiatives?**

9. **Should the DFSA consider any of the industry standards for the purpose of our thinking on sustainable finance? If so, what should our role be given that these standards are voluntary?**

10. **Do you see any of these standards becoming sufficiently prevalent and ingrained so as to render regulatory intervention unnecessary?**

11. **What is the most effective way for the DFSA to co-operate with other UAE authorities towards the development of sustainable finance in the DIFC and the UAE?**

12. **Do you support the idea of the creation of the DIFC Green Hub and, if so, do you have any other comments or suggestions as to its objectives, operation and activities?**

13. **Do you have any comments related to the options discussed in this section (3B)?**

14. **In your experience, which of the sustainable bond standards is likely to reflect your needs when seeking issuance in the DIFC?**

15. What are your views on the opportunities and challenges related to developing a smaller issue size bond market for sustainable issuers or projects in the DIFC?

16. Do you have any comments related to the issue of disclosure obligations in relation to sustainability?

17. Do you have any comments in relation to your firm's ability to make the disclosures under the TCFD Recommendations?

18. Would the DFSA 'comply or explain' approach facilitate and foster your firm's commitment towards using the TCFD Recommendations?

19. Would DFSA guidance on a 'comply or explain' basis in relation to ESG-labelled products foster customer confidence and reduce the risk of 'greenwashing', while not adversely affecting the development of this area?

20. Do you have any comments on issues related to the verification services or service providers?

21. Do you have any comments on the DFSA's plans to adapt our supervisory approach to address sustainable finance issues?