SUSTAINABLE FINANCE

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KEY ISSUES

Objective of the Communication: The Commission is pressing for a more sustainable financial sector.

Affected parties: Financial institutions, rating agencies, market analysts, investors, non-financial companies

Pro: The proposed classification system for sustainability ("EU taxonomy") may support the development of a European market for sustainable financial products.

Contra: (1) Since there is no objective or common understanding of "sustainability", a binding EU taxonomy is misguided. It will lead to a channelling of investments which does not necessarily correspond to investor preferences.

(2) Institutional investors and asset managers should not be obliged to incorporate sustainability considerations into their investment decisions. Where there is demand among investors, providers will take account of sustainability of their own accord.

(3) Reducing the capital requirements for banks by way of a "green supporting factor" will jeopardise financial market stability.

Alternative Approach: Instead of forcing financial institutions and investors to apply the controversial term "sustainability" when allocating their capital, the EU legislator should adapt the rules on which the relevant economic activities are based.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Communication COM(2018) 97 of 8 March 2018: **Action Plan: Financing Sustainable Growth**

Brief Summary

- **Context and objectives**
  - According to the Commission, the current level of investment in the EU is not sufficient to "support an environmentally sustainable economic system". In order to achieve EU climate and energy targets by 2030, additional annual investment of € 180 billion is required. (p. 2)
  - Both "environmental" and "social considerations" are not sufficiently taken into account in investment decisions. IMF studies have shown that income inequality can hamper economic growth. Failure to comply with labour standards can result in "risks to reputation" for companies. (p. 1, 2 and 3)
  - The aim of the action plan is therefore to implement ten "Actions" which will (p. 2)
    - channel capital flows into "sustainable and inclusive" investments (actions 1 to 5),
    - ensure that ecological and social risks are better integrated into the risk management of financial market participants (actions 6 to 8), and
    - make financial and economic activity "more transparent and longer term" (actions 9 and 10).

- **Channelling capital into sustainable investments**

  Action 1: EU classification system ("EU taxonomy") for sustainable activities
  - Shifting capital towards "more sustainable" economic activities can only succeed if there is a clear understanding of what 'sustainable' means. The proposed Regulation on the establishment of a framework to facilitate sustainable investment [COM(2018) 353; cep**PolicyBrief** to follow] therefore provides for the "gradual" development of an EU classification system for sustainable economic activities ("EU taxonomy"). It first concentrates on measures to mitigate climate change and to adapt to its effects as well as some environmental protection factors. Later, social aspects will also be taken into consideration. (p. 4)
  - In June 2018, the Commission set up an expert group to submit a report on an EU taxonomy with particular focus on "climate change" which would be extended to cover "climate change adaptation" and other environmental activities by Q2 2019.
  - The taxonomy will, in the long term, be incorporated into EU law, such as the banking supervisory rules (p. 4).

Authors: Dr. Bert Van Roosebeke and Philipp Eckhardt | vanroosebeke@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-107 | www.cep.eu

Action 2: Standards and labels for sustainable financial products

– EU standards and labels for sustainable financial products could be particularly useful to retail investors in helping them to choose their investments and channel more investment into sustainable financial products (p. 5).
– The Commission will specify the content of the prospectus for "green bonds" by mid-2019, within the framework of the Prospectus Regulation [(EU) 2017/1129, see cep**PolicyBrief**]. By then, the Commission's expert group is to submit a report on an EU standard for such bonds. (p. 5)
– The Commission will look into creating a voluntary EU-wide label for sustainable financial products, based on existing EU law on the EU Ecolabel (p. 5).

Action 3: Fostering sustainable investment

The Commission wants to promote private investment in sustainable projects by way of financial support and technical assistance. For this, it will bring EU investment support together into a single investment fund which will be backed by an EU budgetary guarantee. (p. 5 and 6)

Action 4: Sustainable financial advice

– Financial advice, whilst taking account of the investment objectives and risk tolerance of investors, does not look at their preferences on sustainability (environment, social and governance factors) (p. 6 and 7).
– In May 2018, the Commission therefore submitted draft amendments to the delegated acts relating to the Markets Directive [2014/65/EU, see cep**PolicyBrief**] and to the Insurance Mediation Directive [(EU) 2016/97, cep**PolicyBrief**] which mean that, in future, advisers will have to obtain information about the client's preferences on sustainability in order to assess the suitability of a financial product. (p. 6 and 7)
– The Commission calls on the European Securities and Markets Authority (ESMA) to include provisions on sustainability preferences in its guidelines on the suitability assessment when offering investment advice and asset management (p. 6). In May 2018, ESMA revised its guidelines on the suitability assessment under the MiFID II Directive [Directive 2014/65/EU]. These state that providers of investment services should ask their clients about their preferences on environmental, social and governance matters (ESMA 35-43-869).

Action 5: Sustainability benchmarks

– "Benchmarks" are indices that allow investors to track the performance and progress of their financial investments. Benchmarks seldom take account of sustainability objectives. In addition, the calculation methods often lack transparency and are "unsound". (p. 7)
– In the proposal for a Regulation on reference rates [COM(2018) 355], the Commission proposes the introduction of two new categories of reference rates (p. 7), namely for
  - low carbon investments and
  - investments with a favourable carbon balance.
– It also wants to adopt delegated acts under the Benchmark Regulation [(EU) 2016/1011] that will increase the transparency of the calculation methods for benchmarks (p. 7).

► **Integrating ecological and social factors into risk management**

Action 6: Sustainable market analysis and ratings

– The Commission complains about the "lack of broadly-accepted market standards" to assess companies' sustainability. It calls for the methods used by market analysts and rating agencies to become more transparent and easier to understand. (p. 8)
– By Q3 2019, the Commission wants to assess whether ratings agencies should be obliged, by way of an amendment to the Rating Agencies Regulation [(EU) No. 462/2013, see cep**PolicyBrief**), to take account of sustainability factors. In so doing, the Commission wants to preserve market access for "smaller players" and allow for the "possible creation of new ratings agencies" "in a highly concentrated market". (p. 7 and 8)
– The Commission calls on ESMA to (p. 8)
  - include environmental and social sustainability information in its guidelines on disclosure for credit rating agencies and
  - consider "additional guidelines or measures, where necessary".
– The Commission will investigate the market for sustainability analyses and ratings and look into measures to encourage this (p. 8).

Action 7: Sustainability obligations for institutional investors and asset managers

– Institutional investors - such as insurance companies and investment funds - as well as asset managers are obliged under EU law to act "in the best interests" of their end-investors or beneficiaries. However, whether they also have to consider sustainability factors is "neither sufficiently clear nor consistent across sectors". Also, end-investors are not sufficiently informed about the consideration given to sustainability factors. (p. 8)
– With the proposal for a Regulation on the obligations of institutional investors and asset managers regarding sustainability factors [COM(2018) 354; cep**PolicyBrief** to follow], the Commission wants to ensure that they integrate sustainability factors into their investment decisions in the future and make them transparent for end-investors. (p. 8 and 9)

Action 8: Prudential requirements for banks, insurance companies and pension funds

- Banks, insurance companies and pension funds are exposed to risks arising from "unsustainable economic development". The Commission wants prudential regulation to provide "better reflection" of the environmental and climate-related risks without jeopardising the risk-based nature of EU supervision. (p. 9)
- In 2018 and 2019, the Commission wants to examine whether the risks associated with climate and other environmental factors should be given greater consideration in the capital requirements for banks - such as in the form of a "green supporting factor". In this regard, the EU taxonomy (cf. action 1) will serve as a basis. (p. 9)
- The Commission will commission the European Insurance and Occupational Pensions Authority (EIOPA) to examine the impact of prudential rules for insurance companies on sustainable investments, with a particular focus on "climate change mitigation" (p. 9).

► **More transparency and long-termism in financial and economic activity**

Action 9: Disclosure

- Investors and "stakeholders" should be better able to assess companies' "long-term value creation" and their "sustainability risk exposure" (p. 9 and 10).
- For this purpose, the Commission will adopt new climate-related guidelines for the Directive on disclosure by non-financial companies [2014/95/EU, see cep**PolicyBrief**).
- In addition, it will look at "alternative accounting treatments" to fair value measurement for long-term investment of equity instruments.

Action 10: Sustainable corporate governance and capital market short-termism

- "Undue short-term market pressures" in capital markets may "make it difficult" for long-term corporate strategies. The focus on "short-term financial performance" means that environmental and social risks to companies are ignored. (p. 11)
- The Commission will examine (p. 11)
  - whether companies should be obliged to develop and disclose a sustainability strategy with "appropriate due diligence throughout the supply chain" and measurable sustainability targets, and
  - the need for clarification of the rule that directors should act in the company's "long-term interest".
- The Commission calls on the EU Securities and Markets Authority (ESMA) to collect evidence of "undue short-term pressure" from capital markets; in this regard it will also examine how long asset managers keep their equity holdings.

Policy Context

The foregoing Action Plan is linked to the Paris Climate Change Agreement of 2015 and the UN 2030 Agenda for Sustainable Development. At the end of 2016, the Commission appointed an expert group on sustainable finance which published its Final Report at the end of January 2018. The Action Plan is based on the recommendations contained in this final report.

Options for Influencing the Political Process

Directorates General:	DG Financial Stability, Financial Services and Capital Markets Union
Committees of the European Parliament:	Economic and Monetary Affairs (leading)
Federal Ministries:	Finance
Committees of the German Bundestag:	Finance

ASSESSMENT

Economic Impact Assessment

Investors are increasingly starting to ask about "sustainable" financial products. They require the necessary information in this regard in order to make a sound investment decision. Whilst institutional investors are able to gain their own insight into the sustainability of financial products, retail customers generally rely for their assessment on ready-made information, in the form of labels or ratings, due to the costs and complexity involved.

The proposed classification system for sustainability ("EU taxonomy") with EU-wide criteria for assessing the "sustainability" of a financial product **may support the development of a European market for sustainable financial products**, generate economies of scale and provide the operators of sustainable projects with an EU-wide pool of potential sources of finance. **There is, however, no objective or common understanding of "sustainability".** Non-governmental initiatives use numerous criteria to classify sustainable activities and, in case of a conflict of objectives - such as between ecological and social objective -, also give them a different weighting. The imposition of **a binding EU taxonomy** for "sustainability" as a basis for regulatory provisions, EU labels or ratings **is therefore misguided**. **It** cannot reflect the varying ideas of investors and lenders and therefore **results in a channelling of private investments ("nudging") which does not necessarily correspond to investor preferences.**

The same applies to the obligation for financial advisers to ask about and **take account of the sustainability preferences** of investors **on the basis of the EU taxonomy**.

Institutional investors and asset managers should not be obliged to incorporate sustainability factors into their investment decisions – especially not on the basis of a mandatory EU taxonomy. **Where there is demand among investors, providers will take account of sustainability of their own accord** in order to remain competitive.

Reducing the capital requirements for banks by way of a "green supporting factor" presupposes that allegedly "sustainable" investments are less risky than other types of investment. There is, however, no evidence for this. It therefore **jeopardises financial market stability.** In addition, it results in a questionable steering of industrial policy under which allegedly non-sustainable business, though lawful, is penalised via higher financing costs.

Equally, companies should not be pressured, by way of "climate-related guidelines", to publish information on "long-term value creation" and ""sustainability risk exposure" which is not directly relevant to the success of the company.

The obligation for companies to consider "long-term interests" as well as develop and disclose "sustainability strategies" with "measurable sustainability targets" and "appropriate due diligence throughout the supply chain", is also misguided. The fact that investors and companies also pursue short-term interests is not prohibited, it is legitimate and not necessarily inferior to a long-term strategy. Corporate strategies that only pay off because their negative environmental impact is ignored, can be curtailed much more effectively by way of regulation than inevitably vague governance requirements.

There is no reason for major changes to the regulatory provisions applicable to financial institutions. Although physical environmental risks (such as flooding or storm damage due to global warming), transitional risks (such as the challenging of established technology like that of the combustion engine in light of European CO_2 reduction targets) and social factors (such as corruption scandals) also involve risks for financial institutions, these are already comprehensively addressed by ratings agencies or by the financial institutions themselves**.** Financial supervisory authorities also have significant scope for ensuring that these risks are adequately taken into account.

Legal Assessment

Legislative Competency

Dependent on the design of the individual legislative measures (cep**PolicyBriefs** to follow).

Subsidiarity and Proportionality with Respect to Member States

Dependent on the design of the individual legislative measures (cep**PolicyBriefs** to follow).

Compatibility with EU Law in other respects

Dependent on the design of the individual legislative measures (cep**PolicyBriefs** to follow).

Impact on German law

Dependent on the design of the individual legislative measures (cep**PolicyBriefs** to follow).

Alternative Approach

Instead of forcing financial institutions and both institutional and private **investors to apply the controversial term "sustainability" when allocating their capital, the EU legislator should adapt the rules on which the relevant economic activities are based**: Very often, negative effects can thus be internalised – e.g. greenhouse gas emissions by their cross-sector inclusion in the EU Emissions Trading System (see on this cep**Input**]; other externalities by way of rules on liability. If this is not possible, products and activities can be regulated directly and, if necessary, prohibited.

Conclusion

The proposed classification system for sustainability ("EU taxonomy") may support the development of a European market for sustainable financial products, but there is no objective or common understanding of "sustainability". A binding EU Taxonomy is therefore misguided. It will lead to a channelling of private investment ("nudging") which does not necessarily correspond to investor preferences. The same applies to the obligation for financial advisers to take account of sustainability preferences on the basis of the EU taxonomy. Institutional investors and asset managers should not be obliged to incorporate sustainability considerations into their investment decisions. Where there is demand among investors, providers will take account of sustainability of their own accord. Reducing the capital requirements for banks by way of a "green support factor" will jeopardise financial market stability. Instead of forcing financial institutions and investors to apply the controversial term "sustainability" when allocating their capital, the EU legislator should adapt the rules on which the relevant economic activities are based.