NGO recommendations for the EU Sustainable Finance Action Plan

The European financial framework should be reformed in order to align EU financial policies and legislation with environmental, social and governance factors (ESG), notably from international agreements like the Paris Agreement and the Sustainable Development Goals (SDGs). The European financial system still has many barriers to overcome but also offers opportunities.

The European Commission has taken first steps towards a more sustainable financial system, including integrating sustainability considerations into the IORPs II Directive, the Shareholder Rights Directive, the STS regulation, the Non-Financial Reporting Guidelines and the 'ESAs package' and prioritizing sustainability in the Capital Markets Union Midterm Review Action Plan.

At Member State level, the UK has launched a plan to accelerate the growth of green finance. Sweden has created a 'Swedish toolbox' for a sustainable financial system with some initiatives like, for example, the Swedish FSA's ambitious agenda to integrate sustainability into its daily work. France, one of the leading Member States on sustainable finance, has implemented mandatory ESG disclosure (Article 173) as part of its Energy Transition Law, and its new 'Acceleration' initiative urges the transition to a sustainable financial system. The increasing amount of national initiatives signals political support to standardise and mainstream ESG also on the European level.

The High-Level Expert Group on Sustainable Finance (HLEG) has already provided eight early recommendations in its Interim Report published in July 2017, focusing on several relevant issues. The final recommendations to be published by the end of the year will include a number of new policy areas currently under discussion. The ongoing national and international initiatives in sustainable finance brings an unprecedented momentum at the same time as the HLEG is calling for capital to mobilise on two imperatives: financial stability and inclusive growth[1]. This comes at a time when the merits of sustainable finance begin to stack up, political support is rising, and investors increasingly becomes interested in the evident profitability of sustainability. Good practices and ESG principles will visibly contribute to European growth and a prospering sector.

At the global level, frameworks such as the Paris Agreement on climate and the Agenda 2030 including the Sustainable Development Goals (SDGs) set universal minimum standards for sustainability. The G20 discussions and the FSB Task Force on Climate-related Financial Disclosure (TCFD) provide further advances on the mandatory disclosure by financial institution of their exposure to the risk of climate change, and their mitigation strategies. While in addition the Global Deal[2] addresses inclusive growth and sets standards for social dialogue in a globalization process that benefits all.

All these initiatives create an unprecedented momentum on sustainable finance that should be harnessed by the European Commission in order to deliver bold and ambitious financial regulatory reform producing systemic change.

On the basis of the HLEG final recommendations, the Commission committed to develop an **EU Sustainable Finance Action Plan** that we understand will be published in February 2018. We welcome the European Commission's initiative to create an overarching sustainable finance strategy and hereby propose concrete recommendations that we consider of utmost importance for such an Action Plan.

We NGOs have been individually, and in some cases collectively, working to reform Europe's financial sector for a number of years. Together we represent nine member organizations. Based on this long-term engagement, we have put together this anthology of analysis, positions and recommendations for what we consider to be the priorities for an EU Sustainable Finance Action Plan.

ESG TAXONOMY, STANDARDS AND LABELS

The need for a robust and mandatory mechanism for assessing, mitigating and disclosing environmental, social and governance risks in the finance sector

Authors: Megan MacInnes (Global Witness), Tom Picken (Rainforest Action Network) and Anne van Schaik (Friends of the Earth Europe).

The voluntary and self-regulatory nature of Europe's mechanisms for assessing and mitigating the environmental, social and governance (ESG) factors and risks of financial investors is resulting in inconsistent application, causing social and environmental harm, and exposing the sector to financially material costs. An overarching taxonomy (ie. definition) of ESG risks, implemented through a mandatory methodology of due diligence, disclosure and accountability is urgently needed.

European investors, particularly those from the UK, Germany, Netherlands and France, are involved in many large-scale overseas agribusiness projects.[3] For example, EU financial institutions are major holders of shares in stock-market listed agricultural companies based in developing countries; in early 2015 the top 20 EU institutional investors held US$2.8 billion.[4] European investors are financially involved in projects causing land grabbing, human rights abuses and deforestation overseas.[5]

These investments don't just carry ethical concerns; they also risk financially material impacts for corporations and investors.[6] The average operating costs of a three-year US$10 million project could increase by 29 times if disrupted by local opposition[7] and companies which fail to address disputes with local communities are increasingly losing their licenses.[8] Consequently some are proactively divesting; the Norwegian Government Pension Fund Global has withdrawn investments from a significant number of palm oil and logging companies over human rights and tropical deforestation concerns.[9]

Corporations and investors involved in such projects are also losing out on the investment opportunities of operating responsibly; numerous studies have shown that integrating ESG factors into the investment process has an overall positive impact on corporate financial performance.[10]

Europe's financial sector can no longer ignore ESG risks – neither the harm caused nor the opportunities missed - however progress is restricted by two major regulatory challenges. Firstly, EU investors are currently expected to define their own risks, on a voluntary basis, leading to inconsistent application and disclosure, and inhibited external monitoring.[11] Secondly, even for those regulations which do specify ESG risk management, adherence is non-binding, based on a "comply or explain" model.[12] Consequently, there are very limited means through which such investors can be held to account; either by those harmed by these projects on the ground, or by those whose finances are being put at risk.

The flaws of reliance on non-binding measures are well-documented;[13] the UNEP's Inquiry into the Design of a Sustainable Financial System concluded that sustainability reporting had not yet proven to have had any improvements in social or environmental performance on the ground.[14]

RECOMMENDATIONS

Binding mechanism for assessing and mitigating ESG risk

The sustainable transformation of Europe's financial sector is contingent on guaranteeing the full integration of ESG risk systems into on-going decision-making along all investment and lending chains. Given the failure of existing market-based measures to achieve this, regulatory routes must be introduced. We recommend that such regulations involve a standardised taxonomy of ESG risks adopted by all investors and firms across Europe, which is then implemented through a binding, statutory-based methodology.

1) An ESG risk taxonomy

The ESG risk taxonomy should build on sustainable development as defined in the Agenda 2030,[15] the Sustainable Development Goals, incorporate commitments from the Paris Agreement and be in line with international human rights, labour and environmental laws and policies:

- Environmental risks – broad-based negative environmental impacts, including climate change risks, resource depletion, waste, pollution and deforestation;
- Social risks – all existing human rights obligations, customary rights, worker's rights, women's rights, health and safety, and conflict situations;
- Governance risks – including internal corporate governance, tax strategies, board strategy and diversity, and measures to tackle corruption and money laundering.

As such, we cautiously welcome the Commission's "Public consultation on institutional investors and asset managers' duties regarding sustainability" and the definition of sustainability factors, and environmental social and governance issues which it adopts.[16]

The EU, particularly financial supervisory authorities, should then develop a methodology for systematically embedding this ESG risk taxonomy within binding financial regulations, for example the AIFMD, SRD II and IORP II. Such regulations would need to comprise of robust due diligence, improved disclosure and effective accountability.

2) A mandatory methodology of due diligence, disclosure and accountability

a) Due diligence requirements across the full range of intermediaries in the investor and lending chain, which assess their ESG risk, as follows:

- Requires investors to consider their on-going financially material ESG risks as well as actual or potential social and environmental impacts (e.g. building upon the Non-Financial Reporting Directive, Articles 19, 19(a), Recitals 3, 6, 6(a) and 6(b));
- Requires investors to develop a time-bound engagement policy with those they invest in (e.g. based on Shareholder Rights Directive Article 3(g)(a)) which requires firms (etc.) to assess ESG risks and take adequate steps to avoid or mitigate them;
    - Including obliging issuers and intermediaries promoting investments in land-based projects to include in prospectuses proof of "good title", ensuring that the land has not or will not be grabbed.

b) Disclosure requirements along the entire range of intermediaries in the lending and investment chain, to improve transparency around the due diligence relating to ESG risks, as follows:

- The financial industry and firms should be required to publicly disclose via their annual reports their exposure to financial and non-financially material ESG risks and how they are exercising due diligence to avoid, minimise and mitigate them;
- Such disclosure should be fully mandatory, and implementation should be independently verified, rather than self-assessed.

c) Robust accountability mechanisms are introduced by EU institutions, particularly Supervisory Authorities, to ensure that this model of ESG risk due diligence and disclosure is comprehensively implemented by financial investors.

Where failings are identified, there should be opportunities for policy revisions, procedures for penalising instances of noncompliance, and a transparent grievance mechanism for third parties to bring complaints.

EUROPEAN GREEN BOND STANDARDS

Authors: Sebastien Godinot and Julia Linares (WWF)

We recommend the Commission to set up official EU green bond standards in the course of 2018. We believe there are several critical elements needed to help the green bond market to maintain and enhance its credibility and grow significantly.

RECOMMENDATIONS

- Green bond standards should cover and address all critical environmental challenges and expand to sustainability (ie including social) as a second step;
- They should be science-based, long-term oriented and resilient;
- They should build on an EU official, granular green taxonomy to determine what is green;
- They should include standardised disclosure to demonstrate actual environmental benefits;
- They should include periodic reporting on environmental impacts of the underlying assets, including checking that the effective use of proceeds complies with the Green Bond standard granted upon issue, and the withdrawal of the Green Bond denomination if the effective use of proceeds is found not to comply;
- They should include a second party review;
- They should include independent third-party assurance and accreditation;
- They should include standardised certification for accredited verifiers;

- Existing initiatives can provide shortcuts and help close existing gaps in the meantime (for example Climate Bond Initiative, Green Bond Principles, etc).

In addition, much concern remains over the additionality of green bonds and whether they help to finance new green projects or not. More information is needed throughout the whole bond market to become able to assess the additionality of green bonds - and also to avoid focusing only on a green bond niche and aim to mainstream it in the whole bond market and assess the real economy impacts. We therefore recommend the Commission to require minimum sustainability disclosure for the whole EU bond market.

LEGAL DUTIES OF INSTITUTIONAL INVESTORS, ASSET MANAGERS AND OTHER INTERMEDIARIES

Author: Eleni Choidas (ShareAction)

Institutional investors, primarily pension funds and insurance companies, account for 73% of total assets under management (AuM) in Europe, making them the asset management industry's primary client.[17] The sheer size of these assets makes these investors, and the managers investing their money, powerful economic actors with significant leverage over the behaviour of both governments and companies. Eurosif's 2016 SRI Market Study[18] concluded that one of the strongest drivers for responsible investment amongst these actors is the certainty that sustainability forms part of their fiduciary duty. Nonetheless, as the Interim Report of the High Level Expert Group on Sustainable Finance (HLEG) has determined, it is commonly the case for investors to interpret their legal duties as tied to profit maximization through short and medium-term investments, not considering either the preferences of their beneficiaries or clients ("end-investors") nor the impact of their investment on communities and the environment. The demonstrated potential of fiduciary duty as a driver for responsible investment should provide a strong signal to policymakers that legal clarity in this area is necessary. Investors need to operate under the certainty that environmental, social and governance concerns are not antithetical to the proper discharging of their legal duties, but rather, central to it. In addition, they should be encouraged to take into account the wide interests of end-investors, which go beyond strictly financial considerations.

RECOMMENDATIONS

Scope

Legal duties outlining the highest standards of care should apply to all actors across the investment chain exercising discretion of another's money, or those contracted to advise on managing another's money, including external investment consultants and proxy advisers.

Financial materiality

- Where environmental, social and governance factors are financially material, they should be incorporated in the investment decision-making process as part of mainstream financial risk management.

Wider interests of the end-investor

- Where environmental, social and governance factors constitute non-financial interests of the end-investor, they should be considered in the investment decision-making process.It is not always the case that such factors may have an immediate financial effect on the performance of a portfolio, but should still be considered in the best interest of the end-investor. The following need to be considered in determining the best interest of the end-investor:
  - the impact of any investment activities on the financial system and the economy;
  - the impact of any investment activities on communities and the environment;
  - the implications of any investment activities for end-investors' quality of life, and
  - the ethical views of end-investors.[19]
- "The best interest of the end-investor" is to be determined in active consultation with the end-investor, through predictable and standardised engagement procedures, such as open meetings, webinars, etc.; This process should be undertaken throughout the investment lifecycle;
- The timeframe of the investment decision-making process should reflect the timeframe of the end-investor, in particular when referring to beneficiaries of pension funds, as they have inherently long-term interests. A set minimum investment horizon for pension funds could also be recommended.
- In the case of pension funds, investment decisions should be undertaken in adherence to the principle of impartiality. This would require that younger beneficiaries not be in a disadvantaged position in relation to older ones, which can occur when trustees fail to take long-term investment risks into account, such as those related to climate change.

Disclosure and stewardship

Mandatory disclosure should form part of communicating with end-investors and the wider public – both in the pre-contractual phase and subsequently throughout the duration of the investment. Information disclosed should include:

- Investment beliefs, including which ESG factors are considered and which are not, as well as the reasoning behind this decision.
- Past performance on integrating ESG considerations over the preceding five years.
- In the case that an investment strategy incorporating ESG considerations is absent, a clear plan on how such a strategy will be developed.
- How end-investor interests (financial and non-financial) have been ascertained and incorporated in the investment decision-making process.[20]
- Major holdings and stewardship activities, including how shareholder rights are exercised and how passive investment vehicles may influence this process.

Asset management mandates

- Asset management contracts should include clauses on due diligence of investments and reporting of ESG factors. According to research by RobecoSAM,[21] only 6% of asset owners include ESG-related reporting in their asset management contracts. This is attributed primarily to lack of legal clarity over the role of ESG integration in investment decision-making.

- Asset management contracts must specify that the mandate given to them reflects the interests of the original end-investor. In addition, there should be ongoing monitoring of the asset managers' performance on ESG factors, beyond the original process of selecting an asset manager.

Due diligence and engagement

- Due diligence should form part of the stewardship duties of investors, understood both as a process undertaken before an investor proceeds with an investment, and as an ongoing process throughout the investment lifecycle. Without proper due diligence, it is likely that even investments that are channelled towards sustainable projects may have unintended negative consequences that are not properly accounted for. This is very significant when considering the vast amount of capital that financial institutions have pledged to mobilise in the fulfilment of the Sustainable Development Goals (SDGs), without nonetheless, being bound to avoid doing harm in the process of seeking to "do good".

- Investors and asset managers can be better fiduciaries by setting out expectations for investee companies to identify and mitigate ESG-related risks. While which ESG factors are incorporated in investment decision lies with the investor, the thorough effect of the investment decision on the environment and relevant stakeholders needs to at least be identified and disclosed. Without this process, it cannot be reliably said that the end-investors has accurate information on how their money is invested. The OECD Guidelines for Responsible Business Conduct for Institutional Investors can serve as a framework for how due diligence should be undertaken, and mandatory minimum standards should be developed.

- While we welcome the engagement provisions of Directive (EU) 2017/828 (Shareholder Rights' Directive) in this respect, "the comply or explain" model on which it is based is often not effective in ensuring stewardship function as a driver for responsible investment and responsible business product. As such, minimum mandatory engagement requirements should form part of how investors legally discharge their duty to act in their best interest of their client.

Informed consent

- A duty of informed consent must govern how information on retail products is distributed, including under the proposed regulation for a pan-European Personal Pension Package (PEPP), as outlined in COM(2017) 343. This duty would require retail product providers to disclose the potential financial risks connected to the product to the prospective client, as well as risks connected to the influence on the environment and communities, to financial stability and the health of the economy. A duty of informed consent would deem the current key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPS) under regulation (EU) no 1286/2014 insufficient, as ESG factors form part of KIDs when the respective PRIIP has a demonstrated environmental or social objective. These risks should be identified and communicated to the end-investor independently of whether a retail product has a such a demonstrated objective or not. In essence, there should be no difference in the due diligence undertaken for explicitly "sustainable" products and other retail products. This information is necessary to ensure a duty of informed consent is properly discharged.

Presumed consent

- There are certain investments which, by the nature of how they are reasonably expected to interact with ESG factors, could be considered imprudent independently of whether end-investors are consulted or not. Such investments may involve corporate entities which have been linked to the clear breaches of widely accepted norms, such as those laid out in the Core International Human Rights Instruments. In these cases, there should be legal latitude for the investor to exclude these types of investments without consensus from the end-investor or wide consensus when dealing with a class of end-investors, such as pension beneficiaries. This decision can be based on a presumed consent principle, which would imply that end-investors, unless actively opting out, would consent to the avoidance of imprudent investment practices.

The role of the European Supervisory Authorities (ESAs)

- The recently released COM 2017 (542), " Reinforcing integrated supervision to strengthen Capital Markets Union and financial integration in a changing environment", proposes a strong sustainability mandate to the supervisory duties of ESAs. These authorities have a strong role to play in ensuring investors discharge their legal duties properly, through monitoring how ESG factors are identified and incorporated in the investment decision-making process, and subsequently communicated. This could include, inter alia, the release of best practices on due diligence, stewardship activities, end-investor consultation and engagement, as well as incorporation of these considerations in granting authorization for the distribution of pension products, such as through the proposed regulation on a pan-European Personal Pensions Product (PEPP).

DISCLOSURE

Authors: Julia Linares and Sebastien Godinot (WWF)

There is a lack of disclosure of useful sustainability data to ensure well informed investment decisions. The importance of such information for millions of EU citizens' savings and pensions, and for the overall stability of the financial system, will only grow as the Paris Agreement and the Sustainable Development Goals are implemented. Michael Bloomberg, Chair of the FSB TCFD, made clear that "Increasing transparency makes markets more efficient, and economies more stable and resilient".[22] Without comparable, reliable and decision-useful data on material climate and wider ESG-related issues, the market cannot accurately value companies; neither can investors effectively allocate capital – which is leading to capital misallocation; nor can they enhance their contribution to EU climate and sustainability objectives.

At Member State level, France[23] pushed for mandatory TCFD reporting during the September NYC Climate Week 2017 and has already put in place a mandatory requirement for environmental, social and governance (ESG)-related financial disclosure (Art 173 of the Energy Transition Law); the UK[24] government has launched a plan to accelerate the growth of green finance - including an official endorsement of the recommendations published by the FSB TCFD - and encourages all listed companies to implement this new framework to align climate-related risk management and financial governance; Sweden's Finance Minister stated the importance of working at EU level to strengthen the sustainability competences at the European Supervisory Authorities, in close connection with TCFD recommendations;[25] and the German government is conducting a study[26] to assess the feasibility of regulation on sustainability disclosure requirements for financial actors, similar to those in the French Energy Transition Law.

The High-Level Expert Group on Sustainable Finance made an early recommendation in its Interim Report[27] on the issue: "The recent TCFD recommendations should be integrated in a way that advances EU leadership on these areas, while providing legal certainty and maintaining a level playing field globally. The 2018 review of the Non-Financial Reporting Directive represents an opportunity." We therefore believe that the EU needs to harness this unprecedented momentum on sustainable finance and, more specifically, on climate and wider ESG-related financial disclosures.

In particular we endorse the following key elements of the TCFD recommendations:

- The recommendation for all sectors to structure reporting on four issues: governance, strategy, risk management, metrics and targets;
- The recommendation to perform forward-looking climate scenario analysis (notably under a well below 2°C or 1.5°C scenario);[28]
- The recommendations apply both to non-financial corporates and financial institutions.

RECOMMENDATIONS

We concretely recommend the Commission to:

- Immediately endorse the FSB TCFD recommendations and commit for EU mandatory implementation to ensure an EU level playing field and harmonise climate reporting.

- Prepare the integration of the FSB TCFD recommendations in the Non-Financial Reporting Directive (NFRD), to be reviewed in 2018, with additional measures to include climate risks from the land-use sector. As an entry point the NFRD Guidelines published by the Commission in June 2017 already mention TCFD. Using a well below 2°C standardised scenario for forward looking climate scenario analysis is critical to ensure comparability of results. The timeline of a few years until the reviewed NFRD is transposed in national law and enters into force is adequate: it will enable companies and financial institutions to build on existing climate risk disclosure and develop best practice and operational guidance;
- Similarly, urge the International Organization of Securities Commissions (IOSCO) to issue a recommendation that listing requirements from stock exchanges integrate TCFD requirements for listed companies. This is critical to ultimately ensure a global implementation of the TCFD recommendation - not limited to the EU;
- Through the review of the NFRD, set up a few Key Performance Indicators for all sectors and sector-specific KPIs to report key ESG issues. They are critical to ensure strategic reporting on the most important issues by sector, ensure comparability between peers, and streamline reporting requirements to substantially limit reporting costs. Multi-stakeholder groups should be convened by the Commission at sector or subsector level with a one year mandate and the aim to define a limited set of KPIs for the most meaningful and strategic possible ESG reporting.

CORPORATE GOVERNANCE AND DIRECTORS' DUTIES

Authors: Filip Gregor (Frank Bold) and Jeroen Veldman (Cass Business School)

The High-Level Expert Group (HLEG) on Sustainable Finance identifies short-termism as one of the major challenges in transforming the financial system into a more sustainable one and encourages the European Commission to open a policy discussion on the corporate governance principles for both financial actors and public corporations.

Corporate governance may be broadly understood as the way corporations are administered and structured, by whom, by what and for whom (which purpose). From the 1970s onwards, mainstream corporate governance models have narrowed until the purpose of the corporation has become equated with the maximisation of shareholder value.[29] It is the dominance of this model that leads companies to prioritise short-term profits at the expense of innovation, sustainability, and both employee and societal well-being. This is mostly done by raising the proportion of corporate profits spent on dividends and share buybacks, by engaging in mergers and acquisitions, and by externalising costs.

This model is particularly problematic in sectors that require long-term investments in R&D or innovation. It has also contributed to a race to the bottom in wages in the EU and to exploitative conditions in global supply chains. The efforts to promote sustainable finance therefore require a proper consideration of the influence of short-termism in corporate governance theory and practice; otherwise the effectiveness of this endeavour on the real economy would remain limited.

RECOMMENDATIONS

There are four key areas that can help realign corporate governance of European listed companies towards sustainability and the long-term:

Protect listed companies from pressure to prioritise short-term shareholder value over long-term strategies

The current narrow understanding of corporate governance leads to a disconnect between short and long term goals in business strategy. Policymakers can contribute to the protection of listed companies from short-term pressures through the following hard or soft law changes:

- Clarify the societal purpose of corporations and their duties toward internal and external constituencies;
- Ensure that corporations can effectively protect their purpose in governance documents and arrangements;
- Allow for the use of dual class share structures and industrial foundations;[30]
- Allow the setting up of defensive structures to enable sufficient protection against takeovers;[31]
- Recognise directors' duties to develop long-term plans in order to meet specific societal objectives relevant for their corporation, and to report annually to shareholders on how these plans are being fulfilled.

Clarify company director's fiduciary duties and incentives

Directors have a fiduciary duty to act in the best interests of 'the company', which requires them to take into account ESG factors, in particular when they may have financial impact. However, in practice this duty is often misunderstood to compel directors to prioritise maximising shareholder value, even to the detriment of the company's long-term prospects or societal interests.[32]

Recommendations on how fiduciary duties of corporate directors can be used to restore the focus on long-term value creation include:

- Clarify that directors' duties are owed to the company[33] rather than the shareholders and that it is their duty to:
  - ensure success of the company as a whole;
  - assess and report on environmental and social risks connected to the business of their corporation; and
  - report on how systemic risks and negative impacts on corporate stakeholders and society at large will be mitigated;
- Integrate corporate policies and commitments with respect to ESG and systemic risks[34] in corporate governance documents, strategic objectives, corporate reporting, 'in control' statements, executive KPIs and incentive systems;
- Decouple KPIs and incentive structures, and specifically share-based remuneration, from short-term objectives and financial metrics and link them to long-term strategic goals of the company;
- Enable employees to express their views and engage with executive compensation schemes.

Support the influence of patient capital

Shareholders, and in particular institutional investors can substantially influence corporate strategies and their engagement represents an opportunity to foster patient capital and support long-term sustainable value creation. However, in practice, companies and patient investors often encounter the problem that their influence is outweighed by short-term traders. There are several options to strengthen the impact of patient capital:

- Allow and use multiple classes of shares to vest voting rights with committed shareholders;
- Allocate rights and incentives to investors on the basis of the length of shareholding or contribution to the corporation's capital, including in takeover scenarios;
- Provide for the rights of and means for engagement with funds and companies by end beneficiaries;[35]

Elaborate stronger guidance in corporate reporting and accounting models

Current accounting and corporate reporting models focus primarily on short-term financial information, which complicates the integration of multiple capitals in business evaluation. Recommendations to engage with this situation include:

- Accounting, reporting, and valuation models for non-financial capitals and ESG issues need to be further developed, harmonized and integrated with financial accounting;
- Elaborate in detail the key systemic matters that companies are required to report on in the Non-Financial Reporting Directive, relevant to specific industries and companies business models;
- Clarify that the concept of materiality in non-financial reporting includes three dimensions:
  - the system (i.e. environmental and social issues);
  - the company (i.e. future financial risks or any specific social or environmental goals of the company);
  - the stakeholders, notably including the shareholders.
- Provide requirements and guidance on monitoring and enforcement in the legislative instruments that have been adopted so far to support non-financial reporting, including a requirement for independent verification.

EUROPEAN SUPERVISORY AUTHORITIES (ESAs) AND SUSTAINABILITY – SUPERVISION

Authors: Julia Linares and Sebastien Godinot (WWF)

The European Commission presented on the 20th of September the "ESAs package" to strengthen the supervision of the European financial markets. An important sustainability element is that it explicitly includes a part on "Integrating sustainable finance considerations into financial supervision", and related proposals for regulatory amendments.

This ESAs package was substantially influenced by the discussion occurring in the EU High-Level Expert Group on Sustainable Finance, which included an early recommendation in its Interim Report on "Positioning the European supervisory agencies on sustainability issues".

RECOMMENDATIONS

We recommend the European Commission to:

- Clarify the ESAs mandate:
  - Make explicit that material ESG-related risks are included in their mandate;
  - Clarify concepts and objectives (sustainability, ESG, etc.), to ensure that no relevant ESG-related risk is omitted; this should include but not be limited to climate change;
  - ESAs should also encourage a certain percentage of representatives in stakeholder groups to have expertise on sustainability issues in the financial sector.
- Ensure that ESAs will monitor and check the consistent implementation of ESG integration by financial institutions. A mapping of potential changes in existing level 2 and 3 regulations should be done to avoid gaps. Updating several ESAs guidelines will very likely be necessary.
- As committed to in the CMU mid-term review, the Commission should apply a sustainability test to any new financial regulation, and ensure that ESAs' guidelines integrate ESG-related issues accordingly.
- Ensure that ESAs put in place a monitoring system to assess material ESG risks:
  - It should start in 2018 with forward looking climate scenario analysis: several national financial regulators are already performing or preparing such assessments and such initiatives should be rapidly mainstreamed at EU level. Importantly such analysis should build on standardised climate scenarios, including a well below 2°C scenario, to check portfolio alignment with the Paris Agreement and the climate-related value at risk. This will ensure consistency with the TCFD recommendations;
  - It should then be extended to other significant material ESG risks;
  - Finally, the ESAs should assess and monitor the mismatch of time horizons and investment objectives of financial institutions.

CREDIT RATING AGENCIES

Authors: Julia Linares and Sebastien Godinot (WWF)

Credit rating agencies are critical actors in establishing and maintaining market norms on financial management and governance by issuers in debt capital markets. While the credit rating is an essential market tool, it is currently not integrating long horizon risks or the influence of disruptive ESG trends on issuer's future credit worthiness.

Credit rating agencies partly have a public good role by providing credit ratings to investors and lenders in European markets; such a public good role should be consistent and aligned with the EU sustainability objectives.

However, despite incremental progress credit ratings agencies do not yet properly integrate sustainability factors. Reforms are needed to ensure that they assess and integrate longer term sustainability factors.

RECOMMENDATIONS

We recommend the European Commission to:

- Clarify how credit rating agencies integrate ESG factors in credit ratings methodologies:
  - More disclosure requirements for credit rating agencies on their methodologies;
  - Monitoring of supervisory authorities of credit rating agencies on the systematic integration of ESG factors and longer timeframe of risk assessment in their methodologies;
  - Specifically, requirement for credit rating agencies to communicate whether the issuer's reporting is aligned with TCFD recommendations;
  - Requirement to demonstrate the ESG competence of staff to the supervisory authorities.
- Ensure credit rating agencies provide longer term sustainability information that investors and lenders need for sustainable investing and lending:
  - Require credit rating agencies to integrate longer term sustainability factors in "rating outlooks" – well differentiated from ratings – that apply to all European issuers, showing how a given issuer is exposed to long term ESG risk;
  - Require credit rating agencies to use their privileged access to issuer information to collect and provide additional ESG information to lenders and investors, notably on issuer's alignment with TCFD recommendations.

BENCHMARKS

Authors: Julia Linares and Sebastien Godinot (WWF)

Many investors largely rely on benchmarks to allocate their capital. The use and misuse of standard benchmarks can encourage short-termist behaviour and make investors invest unsustainably. Given several bias, large benchmarks tend to overweight high carbon sectors and underweight low carbon ones. While the rise of ESG, sustainability and climate indexes is an opportunity, even these more recent and sophisticated benchmarks usually remain process-oriented and not outcome-oriented – failing for example to align with the Paris Agreement.

Indices should become a lever to drive sustainability in capital markets: there are opportunities for indices to play a powerful role in supporting and accelerating sustainable investments.

RECOMMENDATIONS

We recommend the European Commission to:

- Require investors to explicitly consider and disclose to what extent their investment beliefs on environmental, social and governance factors have been reflected in their choice of index, both for active and for passive strategies. When opting for passive options, sustainability indexes should be considered for default funds. This should notably apply to the IORP II Directive[36] and the new Pan-European Pension Products.[37]
- Require index providers to disclose sustainability characteristics of benchmarks they market. As a starting point, the climate scenario embedded in each benchmark should be disclosed, to enable better informed decision by investors. Assessing whether a given benchmark is aligned with a 2°C, 4°C or 6°C scenario is already technically feasible and, for example, the Sustainable Energy Investment Metric tool enabling such analysis, funded by the EU research fund Horizon 2020, is open-source and free. Importantly, this will encourage index providers to set up new well below 2°C aligned benchmarks, that are consistent with the Paris Agreement, and wider science-based benchmarks that are consistent with public policy objectives on sustainability. Indeed, it is critical to go beyond process-oriented benchmarks towards outcome-oriented ones.
- Require for passive funds that there is detailed disclosure of the methodologies, including full details of whether and how sustainability is integrated into the methodology. This should be included in the Key Information Document (KID) through delegated act.[38]
- Ensure that the ESMA will include ESG considerations in its guidance on the "Benchmark statement".

THE SOCIAL FACTOR AND LABOUR RIGHTS

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The financial industry is competence-intensive with skilled workers and a catalyst to the green transition. A strong and innovative financial sector can contribute to creating green jobs and limit the outsourcing of key competencies. Investments in research, professional development and production of green financial services will be imperative in the years to come.

It is crucial that the players in the financial industry are competent and updated on how ESG-themes affect investment, society and customers. Education on sustainability and accountability must be part of different training and competence programs, which should be a natural part of company-based training for employees. Furthermore, organized labour should be allowed to play a key part as provider of knowledge about accountability and sustainability. Union representatives and employee representatives in boards are well placed to carry the message of sustainable finance in their companies.

Capital is a crucial tool for change towards a more sustainable European economy. A regulatory framework that stimulates innovation and encourages business development must be aligned with the proper tax incentives to make change possible.

Measures to assess the social impact of investments go hand in hand with efforts to address environmental concerns and climate change. Both in Europe and globally, labour rights and trade union rights are being put under increasing pressure from corporations and investors. Social dialogue and collective bargaining is being undermined across Europe and globally, with notable examples from recent months in Estonia, Slovakia and the Czech Republic. The European Commission's own refusal to make binding the social dialogue agreement on occupational health and safety in the hairdressing sector is another regrettable case in point.[39] Many more examples can unfortunately be raised.

The tendency of undermining collective bargaining threatens the stability of labour markets as it reduces the ability for social partners to find common solutions to the need to adapt to future challenges. Moreover, it weakens wage earners' bargaining power and wage development to the detriment of the purchasing power in general putting demand-driven growth under pressure. Thirdly, it weakens countries' and regions' capacity to handle the effects of globalization and technological change. This in turn increases inequality of income and opportunity both among different social and age groups and between different areas and regions.

The financial sector with its massive assets under management has a key role to play in addressing these concerns and it is therefore vital that the social perspective goes hand in with environmental and governance aspects. The EU commitment is clearly articulated by the TFEU article 151: "The Union and the Member States […] shall have as their objectives the promotion of employment, improved living and working conditions, so as to make possible their harmonization while the improvement is being maintained, proper social protection, dialogue between management and labor, the development of human resources with a view to lasting high employment and the combating of exclusion". We expect the HLEG to take this broader perspective into account.

The recommendations from the HLEG should strive towards integrating environmental and social concerns, and include labour factors as a key element in a future classification system and policy for sustainable finance.

RECOMMENDATIONS

- The financial industry should look to authorities to facilitate debate around ethical considerations and facilitate dilemma training for employees, including integrating ESG into all sector specific training programs
- Transparency on the social impact of investments is urgently needed and metrics should be developed to support this aim. First, certain investment decisions may have profound impact on local employment in an area or region, both positively and negatively, and investors have a right to access this information. Secondly, a financial investment into any given institution may, just as with environmental aspects, impact social factors. For example, the actions of a certain companies or sector may be in breach of the right of collective bargaining, the freedom of association or the right to strike, acknowledged both in ILO Conventions and the EU Charter on Fundamental Rights, or undermine social dialogue.
- In line with the above, classifications or standards of sustainability should entail minimum standards on labour rights. The ShareAction Workforce Disclosure Initiative is an interesting example in this regard. Any such initiative would also imply that, regardless of the design of the framework and the powers invested in the administrator, there must be no worsening of employee's rights in any aspect due to an investment or due to a transition to intelligent and green banking.
- Finance employees are key levers to facilitate the transition to green finance. A continuously sound and sustainable employment situation is a prerequisite. This includes but is not limited to: ensuring training and professional development with regard to green finance, taking into account differences in business models and national practice; providing time and resources for finance employees to provide good advice and exercising their fiduciary duty including integrating ESG factors in the cost-benefit analysis. Tailoring legislation of the financial sector to facilitate long-term prosperity and stable returns.
- Customer-facing staff enhances customer satisfaction in terms of both service and experience - two key aspects that protect the consumers' trust in the sector which in turn stimulates financial stability and transitions to green investing. Moreover, as robo-advice and fintech becomes more common they bring services to geographic locations that before could not be reached. On the flip side, the increasing possibility to monetize human advice risks escalating into pricing that excludes small and medium size investors that will not afford to pay for it. This in at a time where the OECD reports (2017) that financial literacy is worryingly low, and in a disharmonized financial system where the diversity of impact standards can be confusing. This is why affordable and equal access to financial services, including human advice, should be at the top of the sustainability agenda.
- In general terms impact assessments analyzing the effects on employees must be made when drafting new EU legislation including measures on sustainability.
- In addition, the mandate of the ESAs need to be revised, strengthened and clarified in order to enforce the social factors as described above.

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FOOTNOTES

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