Brussels, 20 February 2018

Civil society response to the Final Report of the High Level Expert Group on Sustainable Finance

This statement was compiled with the support of the undersigned to bring attention to both the ambitious scope and the areas of omission in the Final Report of the High Level Expert Group on Sustainable Finance (HLEG).

This HLEG's Final Report is a first step in the European Commission's ambition to re-engineer the financial system so as to integrate sustainability at its core, by reorienting the financial system from short-term profit maximisation to long-term impact and basing it on the Paris Climate Change Agreement and the Sustainable Development Goals.

Whilst the work of the HLEG is highly welcome, the bulk of the work lies ahead.

We encourage the European Commission to put forth an even more ambitious proposal for an EU Action Plan on Sustainable Finance, with concrete actions, which will seek to promote the contribution of the financial sector to the delivery of ambitious environmental and social targets, as well as guarantee the integrity and stability of the financial system as a whole.

We would like to bring attention to the following issues:

- The emphasis on supply-side solutions to channelling capital towards sustainable investments must not detract from the role of optimal government intervention in the accurate pricing of externalities. Identifying and categorising assets, in the format of taxonomies will not sufficiently contribute to redirecting capital towards sustainable investments. Instead what is needed as a basis are financial and economic regulations (like taxation and introduction of standards) that address current market failures. Only suitable financial and economic regulations which **adequately price negative externalities** and make non-sustainable investments not profitable can trigger the creation of sustainable assets at scale.

- We welcome the **broad approach taken to environmental, social and governance (ESG) factors** and risks within the report, particularly reorienting the financial system from short-term profit maximisation to long-term impact, founded on the Paris Climate Change Agreement, the Sustainable Development Goals and the UN Guiding Principles on Business and Human Rights. This is reflected in a range of important proposals, including: a common classification framework for sustainable finance, including social and environmental concerns, extending the time horizons of their asset management; including sustainability within the mandate of the European Supervisory Authorities; and developing investment performance indicators for social and governance factors which build on international human rights law and consider the financial sector's impact on growing inequalities.

- We welcome the report's recommendation on the **need to mandatorily integrate financially material ESG-related risks in the legal duties** of investors as part of mainstream risk management. This is a significant step in ensuring alignment between the long-term liabilities of end-investors and the investment time frame of their asset owners. Nonetheless, we consider this to be an incomplete vision of the proper discharging of fiduciary duty. Case law in the area has shown that **non-financially material ESG-related issues, including ethical considerations,** are equally the subject of an investors' duty, on the basis that they can reflect the interests of beneficiaries. Beneficiary consultation needs to form an essential step of asset allocation, in particular when ESG factors are expected to have no or a potentially negative impact on the performance of an investment. When aligned with the investment timeframe of their beneficiaries, short-term losses may be acceptable upon sufficient consultation and in line with the duty of impartiality. Finally, we encourage the Commission to recognise that properly discharging fiduciary duty is intimately connected to strong disclosure requirements (to beneficiaries, the public and regulators) and stewardship - we welcome the link made between a legislative proposal on fiduciary duty and changes necessary in the revised Shareholder Rights' Directive, as well as the Non-Financial Reporting Directive, also addressed in this statement.

- We regret that measures to **fully integrate ESG factors** in investment decisions of all financial sector actors are less ambitious than expected and we are concerned by the continuing reliance on voluntary instruments, in the face of decades of failing investor self-regulation. Strong legislation, including **transparent and mandatory due diligence** and accountability mechanisms for different actors in the investment chain, is the only way to ensure that Europe's finance and investment industries reconnect to the real economy, to the benefit of citizens, the environment and future generations, including those outside the EU. While making sustainable investment more attractive is a necessary component of the transition to a low-carbon and sustainable economy, it is also imperative to ensure appropriate measures are in place to hold investors to account when they fail to contribute to this transition. It is absolutely necessary to consider that bottlenecks are not just found in the inability to classify assets as sustainable, but also in the lack of strong regulation to ensure investors are held to account for their investment decision-making.

- We welcome the final report's recognition of **disclosure** as a significant enabling force in the creation of a sustainable financial system. We urge the Commission not to base its upcoming Action Plan on voluntary disclosure measures and to ensure strong, forward-looking scenario analysis which should be binding on all actors - starting with the integration of the TCFD recommendations in the upcoming review of the Non-Financial Reporting Directive. We encourage the Commission to build on "disclosure learning and leadership" resources and best-practice guidance already available and used by the market, such as the TCFD Knowledge Hub[1], as well as the technical guidance[2] for companies on how to incorporate and disclose in compliance with the TCFD recommendations on the CDP platform.

- Overall, the creation of a sustainable financial system is predicated on the availability of reliable corporate **reporting data on ESG-related factors and risks**. To this end, the Commission needs to ensure that the upcoming review of the Non-Financial Reporting Directive serve as an opportunity for the development of robust ESG metrics, ideally by sector, as well as reliable processes for the evaluation of ESG-related risk. These processes would, in turn, encourage investors to productively engage with company boards on sustainability issues, as well as inform their overall stewardship activities. Clarifying the duties of company directors is a significant additional step in ensuring that companies are protected from the dictate to maximise short-term shareholder value. This pressure functions contrary to the

[1] TCFD Knowledge Hub, http://www.tcfdhub.org/

[2] CDP, *Guidance for companies*, https://www.cdp.net/en/companies-discloser/disclosure-in-2018

long-term perspective needed for sustainable corporate governance and, by extension, a sustainable financial system.

- We welcome the HLEG's recommendation on **retail strategy on sustainable finance** and we strongly believe that retail investors should be given the possibility to invest in portfolios which reflect their financial and non-financial interests, as those related to sustainability. Green labels for green-themed funds could be a useful instrument in allowing investors to allocate capital according to their preferences, as long as the label is accompanied by sufficient information and is not a simple graphic or icon. Consumers should not have to take a "leap of faith" to trust the credibility of labels. In addition, we believe that all retail funds, whether explicitly "green" or "ethical" or not, should be subject to the same standards of mandatory disclosure and accountability on their performance in relation to sustainability issues.

- While we welcome the proposed **EU Green Bond Standard provisions**, we strongly believe that the external review should be mandatory for the impact monitoring as well, and not at the issuance only as it is now being proposed in the HLEG report.

- We welcome the Commission's early action to propose the integration of sustainability into the mandates of the **European Supervisory Authorities (ESAs)**. Nonetheless, we emphasize that the integration of sustainability factors in financial decision-making is a necessity in order for the ESAs to properly discharge their *current* mandates: consumer protection and maintenance of financial stability. Nonetheless, a formalized recognition of this mandate is a necessary development, and we will fully support it throughout the remainder of the legislative process. We consider the development of a common framework for climate risk scenario analysis, along with the creation of model mandates clarifying the role of ESG factors and risks between different actors across the investment chain, as significant supervisory duties. Supervisory authorities at the national level should be take heed. To this end, we welcome the recent steps of the Dutch Central Bank in identifying the risk that a lack of mitigation of climate change poses to the Dutch financial sector[3], as well as the recognition of sustainability issues as a significant upcoming area in the recently-released 5-year strategy plan of the Autorité des Marchés Financiers (AMF)[4].

- While we welcome the emphasis on the role of micro-prudential supervision in the creation of a sustainable financial system, we regret the inadequate attention paid to the **macroprudential level.** Macroprudential well known tools like countercyclical capital buffers, capital instruments (risk weights) and caps could be used to counter excessive credit growth towards unsustainable business practices. Regarding capital requirement debate between supporters and opponents of a green supporting factor, more evidence is needed to support the case that a green supporting factor will help increase green lending. Also, even if certain categories of brown assets carry extra risk related to stranded assets, we still need more evidence than green assets could reduce systemic risk. A green supporting factor may also create a precedent to lower capital requirements more generally, which would not promote a more stable financial system. However, without a brown penalising factor based on the risks of lending or investing in non-sustainable activities, the incentive - if any - for green finance might be annulled or have marginal effect but undermine financial stability. With these

[3] De Nederlandsche Bank, *Waterproof? An exploration of climate-related risks for the Dutch financial sector,* 2017, https://www.dnb.nl/en/binaries/Waterproof_tcm47-363851.pdf?2017110615

[4] AMF France, *2018-2022 Strategy for the Autorité Des Marchés Financiers*, http://www.amf-france.org/en_US/Reglementation/Dossiers-thematiques/l-AMF/Plan-strategique-de-l-AMF/strategies-2018-2022-de-l-autorite-des-marches-financiers

arguments in mind, the HLEG's final report should have considered both options and their eventual complementarity.

- The **European Central Bank**, which is bound by the Paris agreement according to the last EP's annual report on the ECB, has also a significant role to play in the reduction of carbon emissions and the safeguarding financial stability through the integration of sustainability considerations in its core mandate. Firstly, we would encourage Central Banks, as major holders of securities, to apply to themselves the recommendations of the TCFD, and to start measuring the current and future carbon footprints of their securities portfolios. Secondly, a policy of green credit allocation would provide green targeted refinancing lines through which banks could refinance at a cheaper rate, hence providing an incentive for banks to lend more to the green sector by rewarding them with higher marginal profits. This policy could achieve the same purpose of the 'green supporting factor' by making green loans cheaper without the negative side effects of reducing capital requirements. The criteria of the Eurosystem collateral framework could also be modified to give more recognition to sustainability concerns. The HLEG could have also proposed to better align the ECB's quantitative easing programme (Asset Purchase Programmes - APP) with climate goals by progressively introducing low carbon criteria into the 'eligibility criteria' of the asset purchase programme. In its purest form, a Green QE programme would involve the ECB orienting a larger part of its public bond purchases (PSPP) towards development banks (or similar public intermediaries, such as the EIB and its national equivalents), which in turn could finance green economic projects at a lower interest rate. Recent macroeconomic research[5] shows that a Green QE programme would promote faster development of the green bond market, with positive spill overs to green investments, employment, commercial and central banks' reserves, and on decreasing risk of stranded assets for the financial system.

- We welcome the HLEG's recommendation for the creation of "Sustainable Infrastructure Europe", but emphasize the need for proper regulatory oversight of Public Private Partnerships to ensure these projects deliver on their intended purpose without creating unforeseen burdens on users.

Conclusion

While we welcome the HLEG recommendations included in the final report, we hope that the Commission Action plan will propose concrete and highly ambitious actions and will address the concerns we have highlighted in this statement.

[5] Monasterello, I., Raberto, M., *Is there a role for Central Banks in the low-carbon transition? A Stock-Flow Consistent modelling approach*, 2017