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The Capital Markets Union and sustainability: recommendations for the mid-term review

Key recommendations

Mainstream responsible investment (including integration of ESG factors):

- ➔ Issue guidance on fiduciary duties and ESG issues
- ➔ Integrate the FSB Task Force recommendations in the NFR guidelines
- ➔ Introduce ESG requirement in three relevant EU legislations:
  - Securitisation (STS file)
  - Forthcoming personal pensions proposal
  - Alternative investment funds (AIFMD review)

Redirect capital towards sustainable projects, sectors and companies:

- ➔ Take concrete steps towards EU green bond standards
- ➔ Ensure National Energy and Climate Plans include national capital raising plans
- ➔ Consider an ESG label in the PRIIPs review.

1. Background

In September 2015, the European Commission presented its action plan for a Capital Markets Union (CMU)[1]. This Action Plan built on a Green Paper from February 2015[2], and the public consultation that followed in Spring 2015. In April 2016 the Commission issued a First Status Report[3] to assess the progress made on the CMU Action Plan. Lastly, in September 2016 the Commission published a communication on the need to accelerate CMU-related reform[4].

The midterm review of the CMU is scheduled for June 2017. A public consultation which will run until mid-March has just been launched, seeking feedback on how the CMU can be updated and completed. The outcome of the consultation will be presented at a public hearing on CMU on 11 April 2017. The College of Commissioners will discuss the review on the 7th of June, and the ECOFIN Council will debate on it on the 16th of June.

2. Sustainable finance: a different context today

Since the CMU Action Plan was launched almost two years ago, the political context surrounding the issue of sustainable finance has evolved rapidly and positively at all levels: global, European and national. This notably includes the following initiatives (not exhaustive):

- **France** published in January 2016 the implementing act for the Article 173 of the Energy Transition bill, which requires investors to disclose (in their own way) climate information, notably on how they are contributing to the energy transition. As a result investors will start reporting on that basis in 2017;
- The **European Systemic Risk Board**, the Bank of England, the Dutch Central Bank, the Swedish Financial Authority, and the Central Bank of Finland issued specific reports on potential climate-related systemic risks for financial stability and the need for enhanced disclosure and 'carbon stress tests';
- For the first time ever, the **ECOFIN Council** discussed the issue of sustainable finance in April 2016[5];
- The Commission organised a consultation on long term and sustainable investment[6] in Spring 2016;
- In September 2016, the European Commission announced the creation of a High-Level Expert Group on sustainable finance[7], with the aim of proposing a comprehensive EU strategy on sustainable finance by end of 2017. The members of this group were appointed in December 2016, with the first meetings taking place in January 2017.
- The EU finalised the legislative dossiers of the Institutions for Occupational Retirement Provision (**IORPs II**) Directive on pension funds and the **Shareholder Rights Directive**, that both include ESG-related requirements. The new Prospectus Regulation also refers to ESG (end 2016);
- The Commission published a report on the **green bonds** market in December 2016, recommending EU green bonds standards;
- At the global level, the **G20 Green Finance Study Group** published its first report in August 2016, endorsed then by the G20 Heads of State that recognized for the first time the need to 'scale up green finance'. The G20 Green Finance Study Group continues under the German presidency amongst others with work on 'green' stress testing;

[1] European Commission (30 September 2015), Action Plan on Building a Capital Markets Union, COM(2015) 468 final
[2] European Commission (18 February 2015), Building a Capital Markets Union, COM(2015) 63 final
[3] European Commission (24 April 2016), Capital Markets Union: First Status Report, SWD(2016) 147 final
[4] European Commission (14 September 2016), Capital Markets Union - Accelerating Reform, CTM(2016) 601 final
[5] Discussion based on document prepared by the Dutch Central Bank (DNB) which is continuing to work on sustainability issues with the Dutch financial industry
[6] http://ec.europa.eu/justice/newsroom/civil/opinion/151211_en.htm
[7] http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3485

- The UNEP Inquiry estimated that the number of policy measures to green the financial system more than doubled to over 200 measures across 60 countries;
- The **FSB Task Force on Climate-related Financial Disclosure (TCFD)** issued its draft final report with recommendations with voluntary disclosure guidelines in December 2016;
- The OECD has discussed and will soon release "Key considerations for institutional investors in carrying out due diligence under the OECD Guidelines for Multinational Enterprises: Responsible business conduct for institutional investors";
- Growing **coalitions of private investors** are taking action, including the Portfolio Decarbonization Coalition[8] (US$3 trillion in assets), the Principles for Responsible Investment (US$60 trillion) and related "Montreal Pledge", or the Global Investor Statement on Climate Change (US$25 trillion)[9], publicly urging governments to put in place regulatory frameworks to mitigate climate change;
- The General Assembly of the United Nations endorsed in July 2015 the **Addis Ababa Action Agenda of the Third International Conference on Financing for Development**[10], committing notably to promote incentives along the investment chain that are aligned with long-term performance and sustainability indicators, including in capital market regulations[11];
- Work is on-going on how the financial sector can contribute to the promotion of human rights[12] and the UN sustainable development goals;
- In January 2017, the **World Economic Forum** put income inequality and 'profound social instability' high on the 'Davos' agenda[13]. Wealth redistribution appeared as a major priority and Christine Lagarde, Director of the International Monetary Fund, called explicitly for redistribution, stressing that "*growth will not be sustainable if it is not inclusive*"[14].

As a result, the UNEP Inquiry concluded that "*2016 was the best year ever for green finance*"[15]. **This raises the stakes on sustainable finance for the midterm review of the CMU**: the EU should be at the forefront not lag behind – which requires acceleration as framed in the Commission's communication on the CMU[16]. This communication states: "***The Commission supports alignment of private investments with climate, resource efficiency and other environmental objectives****, both through policy measures and public investment*." This is a welcome commitment that rightly puts the focus on outcomes (alignment) and not only on processes (e.g. disclosure). It should however be noted that sustainability includes not only the environmental dimension but also social and governance dimensions.

The EU has in the past often paid little attention to the contributions to consultations from civil society organisations to ensure that the financial system and in particular the Capital Market Union will be stable, sustainable and equitable. This is particularly noted in the summary of the Commission on its Call for evidence, where the suggestions by several civil society organisations to include ESG criteria were completely ignored[17].

However, we welcome the Commission's consultation on the CMU midterm review[18] that states: "***Capital markets remain under-utilised to redistribute capital from polluting industries into environmental technologies, and investors do not sufficiently integrate wider sustainability factors into investment decisions****, as evidenced by the recent public consultation on long-term and sustainable investment. At the same time, the increasing development of sustainable finance flow can make a sizeable contribution to the achievement of EU as well as internationally agreed climate and environmental goals (e.g. Paris Agreement)*."

[8] http://unepfi.org/pdc/
[9] http://investorsonclimatechange.org/
[10] http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf
[11] The Addis Ababa Action Agenda states (para. 38) that they "*will endeavour to design policies, including capital market regulations where appropriate, that promote incentives along the investment chain that are aligned with long-term performance and sustainability indicators, and that reduce excess volatility*". It also makes a commitment (para. 39) to "*adopt or review our financial inclusion strategies, in consultation with relevant stakeholders, and will consider including financial inclusion as a policy objective in financial regulation*"
[12] See for instance: https://www.ihrb.org/uploads/reports/IHRB_UNEP_Human_Rights_Sustainable_Finance_Feb2016.pdf
[13] World Economic Forum, Global Risks Report 2017, https://www.weforum.org/reports/the-global-risks-report-2017
[14] https://www.weforum.org/agenda/2017/01/davos-leaders-agree-we-should-share-more-of-the-worlds-wealth-or-face-the-populist-consequences
[15] http://www.huffingtonpost.com/nick-robins/2017-what-next-for-green_b_14203706.html
[16] European Commission (14 September 2016), Capital Markets Union - Accelerating Reform, COM(2016) 601 final
[17] http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index_en.htm
[18] https://ec.europa.eu/info/file/76178/download_en?token=YzBmWq-m

Given the urgency of tackling climate change and energy transition as well as social inequality, we put this document forward to ensure that the EU moves to a sustainable transition that benefits people and planet[19].

3. Specific recommendations for the mid-term review of the CMU

We recommend that the Commission swiftly moves forward with the following issues in the midterm review of the CMU. Our recommendations are grouped in two clusters:

- Mainstream responsible investment - including integration of environmental, social and governance (ESG) factors[20];
- Redirect capital towards sustainable projects, sectors and companies.

Mainstream responsible investment

- **Issue guidance on fiduciary duties and ESG issues**

  The European Commission should clarify as soon as possible that ESG risks have to be taken into account in the context of fiduciary duty. There is now overwhelming financial evidence that ESG related issues are financially material[21]. The US Department of Labour[22], the PRI, UNEP FI, UNEP Inquiry, UN Global Compact[23], and the OECD[24] have clarified (or will do it shortly for the OECD) that fiduciary duties must take into account material ESG factors.

  The IORPs Directive[25] partly clarified the ESG issue[26], but more is needed: the Commission should provide guidance during the transposition of the IORPs Directive in national legislations; in addition, the IORPs Directive does not cover all investors that have fiduciary duties. **The Commission has the competency to issue a recommendation**, as already done on the issue of 'comply or explain' for corporate reporting. This guidance should be consistent with the Non-Financial Reporting Directive that refer to different ESG issues. It should be provided to the competent Member States authorities on how they should interpret fiduciary duties in the national legal context[27]. **As a matter of priority, as identified in the Commission's report on Resource Efficiency and Fiduciary Duties of Investors[28], it should be clarified that asset managers and asset owners have a**

[19] While we focus in the briefing on sustainable finance, the Commission needs to also deal with macro-economic and systemic issues to avoid that the CMU encourages unstable finance: the current EU capital markets have many short term instruments that do not limit the herd behaviour of investors, nor risk transfers to non-banks and (retail) investors who might not be able to resist to shocks in the capital markets

[20] With a view to strengthen legislation ensuring that financial institutions are obliged to report on any potential ESG risk and exercise due diligence in the development and promotion of investment packages

[21] See e.g. Deutsche Asset Management and University of Hamburg (2015), ESG & Corporate Financial Performance: Mapping The Global Landscape – the largest meta-study ever that looked at data from over 2,250 individual studies into ESG and found overwhelming results that the integration of ESG criteria positively affect corporate financial performance

[22] US Department of Labor, Interpretive Bulletin (IB 2015-01) on Economically Targeted Investments (ETIs) and Investment Strategies that Consider Environmental, Social and Governance (ESG) Factors, October 2015

[23] PRI, UNEP FI, UNEP Inquiry, UN Global Compact (2015), Fiduciary Duty in the 21st century

[24] OECD (forthcoming), Responsible business conduct for institutional investors : Key considerations for institutional investors in carrying out due diligence under the OECD Guidelines for Multinational Enterprises

[25] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52014PC0167

[26] By requiring occupational pension funds to integrate material ESG factors in their risk assessment process

[27] In addition, EIOPA can issue opinion and guidelines that could clarify how to apply IORP. Given that EIOPA has little expertise in ESG risks issues, the Commission and organisations with ESG expertise should be involved

[28] European Commssion (2016), Resource Efficiency and Fiduciary Duties of Investors - Final Report

duty to pay attention to ESG factors where they are likely to be financially material.
Authorities should also clarify that asset owners and managers are permitted, and indeed encouraged, to take other ESG issues linked to beneficiaries' quality of life or ethical views into account if doing so would not pose a risk of material financial detriment to investments.

The Commission should clarify what ESG means, going beyond a reference to the UN PRI definition, as many investors don't have a comprehensive approach of ESG factors. An ESG definition needs to be developed, with relevant stakeholders, to be used in all relevant EU policies and legislations in order to ensure consistency and foster comparability. This should build on the report the Commission will commission on this specific issue.

In a broader approach to fiduciary duties, another guidance focussing on company directors is needed as well.

- ## Integrate the FSB Task Force recommendations in the NFR guidelines

The Commission is currently drafting voluntary guidelines on Non-Financial Reporting (NFR) to help companies to report on ESG issues. The different ESG issues should be elaborated as much as possible[29].
Given the level of detail on climate related disclosure in the recommendations of the FSB Taskforce on Climate-related Financial Disclosure (TCFD) in its Phase II report[30], the NFR guidelines should:

- Explicitly mention the TCFD's recommendations on disclosure about governance, strategy, risk management, as well as metrics and targets as they relate to the Directive's requirements (notably 'Business model, policies, outcome or principal risks');
- Highlight and encourage report preparers to consider climate-related risk beyond its most limited sense and expand focus on financial risk, social risk, physical risk and nonphysical risk (including transition risk) related to climate change, and include the TCFD recommendation to do climate scenario analysis; and
- Reference established frameworks and guidance, as well as market best practice to support report preparers.

In due course, the European Commission should ensure that all financially material climate and other ESG-related information is published in mainstream financial reports, as recommended by the FSB TCFD, and not in separate non-financial reports.

- ## Introduce ESG requirement in three relevant EU legislations:

1. Securitisation (STS file)

In the STS legislative file[31] entering in trialogue stage, the Parliament introduced an amendment for mandatory ESG disclosure for the securitisation benefitting favourable STS treatment. This would ensure consistency with the ESG requirements in the IORPs Directive and in the Shareholder Rights Directive, and contribute to ESG mainstreaming in EU financial regulations. We ask the Commission to support the Parliamentary amendment.

[29] They should be based on existing work done by the UN Guiding Principles on business and human rights, the OECD Guidelines on MNEs and related guidelines and the Sustainable Development goals amongst others
[30] https://www.fsb-tcfd.org/publications/recommendations-report/
[31] http://ec.europa.eu/finance/securities/securitisation/index_en.htm

2. Forthcoming personal pensions proposal

The Commission opened a public consultation on pan-European personal pension products at the end of 2016[32]. On that basis, it is considering a possible legislative proposal to be tabled in 2017. If the Commission is to proceed, it should ensure alignment of this proposal with IORPs II on ESG issues, to ensure consistency.

3. Alternative investment funds (AIFMD review)

The Alternative Investment Fund Managers Directive (AIMFD)[33], regulating hedge funds, private equity funds, real estate funds and more, was finalised in November 2010 and will be reviewed as from July 2017. It is a crucial opportunity to introduce ESG-related requirements in the risk management process (assessment, disclosure, implementation, governance). It would create inconsistency in EU law to let alternative investment fund managers free-ride ESG-related requirements while other investors have to increasingly factor them in. The AIFMD has in practice allowed, on the one hand, the continuation of socially and environmentally destructive activities by financial players such as hedge funds and private equity funds, but, on the other, has forced environmentally and socially innovative funds managed by ethical banks to come under the AIFMD regime which was not appropriate.

There should be a consideration of facilitating retail and institutional investments in long term and ESG-related investment funds with listed and non-listed securities – e.g. for legislations such as EuVECA, EuSEF, ELTIF, PRIIPs.

Redirect capital towards sustainable projects, sectors and companies

The urgent needs of climate change mitigation and energy transition as well as social inequality means that trillions of euros of investment need to be redirected. Policies and regulations will therefore be needed in addition to encouraging and promoting the mainstreaming of ESG issues. Some concrete proposals for concrete action include:

- ## Take concrete steps towards EU green bond standards

  Credible, fully-developed and widely-accepted sector-specific standards for green bonds are urgently needed to ensure that the market thrives and truly benefits a green economy while not leading to human rights abuses and more inequality. The green bond issue is part of the Capital Markets Union's Action Plan from the very start. In December 2016 the Commission issued a welcome study on green bonds [34] providing a relevant analysis of the green bonds market, including detailed recommendations for the next steps.
  Based on in-depth analyses of six key standardization measures, the study recommends that the EU "*support(s) the emergence of a common European Green Bonds Standard based on the key suggested standardization measures and building on the existing market led initiatives such as the Green Bonds Principles and the Climate Bonds Standards*".
  The Commission should now take such action without delay, with the objective to finalise fully-developed EU green bond standards by mid/end 2018 at the latest. It should convene the relevant stakeholders identified and lay out a detailed policy roadmap including standardised terms and definitions, standardised disclosures, certifications and credit-rating requirements, dispute resolution mechanism and supervision.

[32] http://ec.europa.eu/finance/consultations/2016/personal-pension-framework/index_en.htm
[33] http://ec.europa.eu/finance/investment/alternative_investments/index_en.htm
[34] http://ec.europa.eu/environment/enveco/pdf/potential-green-bond.pdf

In addition, the Commission should ensure that green bond standards include crosscutting ESG measures to avoid that so-called green projects risk conflicting with other ESG issues, and encouragement for long term investment, (i.e. not be able to be redeemed on a day to day basis). Consideration should be given to explore the development and standardisation of social bonds and sustainable bonds (fully integrating social and environmental issues).

- **Ensure National Energy and Climate Plans include national capital raising plans**

  An explicit link should be established between the EU sustainable finance agenda and the Energy Union, by asking Member States to develop National Capital Raising Plans as part of their National Energy and Climate Plans (NECPs) – plans requested in the 2016 Proposal for a regulation on the Governance of the Energy Union.
  This would improve consistency between the EU sustainable finance agenda and EU climate and energy policies, make sustainable investment opportunities more visible to the private sector and increase investor confidence in the NECPs.

- **Consider an ESG label in the PRIIPs review**

  The EC should, in a participatory manner that includes civil society, review the Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs) which is due by 31 December 2018. In particular, the review is legally required to include "*the feasibility, costs and possible benefits of introducing a label for social and environmental investments*." (Art. 33). Given the growing interest in such investments, it will be important that the Commission provides one or more proposals for trustworthy labels supported by reliable supervisory and enforcement mechanisms.

4. Avoid redundancies with the High Level Expert Group's agenda

The EU High Level Expert Group on sustainable finance, set up by the Commission, has the mandate to develop an overarching and comprehensive EU strategy on sustainable finance to integrate sustainability in EU financial policy. It will meet eight times in 2017 and deliver an interim report in June and a final report in December.

The task of the High Level Expert Group is enormous, within a very tight timeframe. To ensure the best possible outcomes, the Commission should ensure that all short term, 'mature' issues on EU sustainable finance should be dealt with immediately by the Commission itself and not be part of the agenda of the Expert Group: this would help to avoid overburdening the agenda of the Expert Group on issues where there is already a large consensus. The Expert Group should indeed focus on far-reaching proposals that will have systemic impact but are not fully mature yet and thus require debate.

The specific issues mentioned above in part 3 are the ones we consider short term, 'mature' issues on EU sustainable finance that the Commission should deal with as part of the CMU mid-term review.

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