Response to Public Consultation by the EU's High Level Expert Group on Sustainable Finance

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Introduction

As part of the European Union's Capital Markets Union project, the High Level Expert Group on Sustainable Finance (HLEG) was established by the European Commission in early January 2017 to help develop an overarching, comprehensive EU strategy on sustainable finance through practical and concrete recommendations.

The questions that we have answered below have been prepared by and under the responsibility of the HLEG in relation to the Interim Report, published in mid-July 2017 and presented at a stakeholder event on 18 July 2017. They are aimed at gathering targeted feedback on the analysis and reflections in the Interim Report and informing the preparation of the final report.

1 General approach to sustainability in finance

Question 1. From your constituency's point of view, what is the most important issue that needs to be addressed to move towards sustainable finance? (sustainable finance being understood as improving the contribution of finance to long-term sustainable and inclusive growth, as well as strengthening financial stability by considering material environmental, social and governance factors).

Shifting finance towards sustainability requires regulatory/supervisory measures as well as action by the financial industry. Regulatory steps should be taken to reduce financial short-termism. Most financial risks associated with ESG factors are long-term or low-probability and do not breach the materiality threshold. They are therefore ignored by financial institutions. Financial institutions should also be forced to internalise directly the costs and risks that are still mostly borne by society. On the industry side, efforts to integrate sustainability concerns into the operations and governance structures of banks, investors and asset managers must be stepped up.

The point is that regulatory action can support industry efforts. Changing the framework in which financial institutions operate to make them lend or invest long term and internalise risks can increase the importance of ESG concerns. Procedures that aim to factor such concerns into decision making are still too often treated as compliance or PR exercises. If, however, they became financially material, the internal importance of these procedures would increase. Regulators can help by obliging financial institutions to focus on the long term, and by discouraging financial products that allow them to liquidate assets quickly, e.g. loan securitisations. Regulators should also explore instruments like lender liability or outright bans on financing socially harmful activities to increase the risk of investing in them.

2 Develop a classification system for sustainable assets and financial products

Question 2. What do you think such an EU taxonomy for sustainable assets and financial products should include?

Recent work on sustainability in finance tends to focus on the environmental, specifically climate, aspect of sustainability. While understandable in light of the pressing need to mitigate human-made climate change, it is imperative that any EU taxonomy be based on sustainability in the broadest sense (see p. 12, HLEG Interim Report). This would also reflect the comprehensive and ambitious scope of the Sustainable Development Goals. The taxonomy also needs to be comprehensive in the sense of covering all important financial instruments – loans, equities, bonds, securitisations, and possibly equity-debt hybrids and derivatives – and it should be applicable by all types of financial institutions and financial sector actors, rather than be sector-specific, as, for example, the Principles of Responsible Investment, which take the point of view of asset managers.

Financial stability, while not a central plank of the Sustainable Development Goals, should be part of the taxonomy too. Regulation should, of course, encourage the flow of funding to sustainable business activities and in particular to the type of capital investment needed to accomplish an energy-transition, but the risk of creating 'green asset' bubbles must also be taken into account.

3 Establish a European standard and label for green bonds and other sustainable assets

Question 3. What considerations should the EU keep in mind when establishing a European standard and label for green bonds and other sustainable assets? How can the EU ensure high-quality standards and labels that avoid misuse/green-washing?

Like the taxonomy, which should take into account all dimensions of sustainability in the broadest sense (p. 12, HLEG Interim Report), labels for financial products should be accordingly differentiated to create competition among financial institutions to become sustainable in the comprehensive sense. For example, bonds that match the criteria for a green bond should not be allowed to be labelled 'sustainable', as long as they do not also match criteria for social, governance and economic sustainability. The 'fully sustainable' label for financial products would thus become a marker of distinction and a competitive advantage for the firms able to offer them. In practice this would mean a multi-dimensional label, akin perhaps to the labelling used in some countries for nutrient content in food items. A single numerical sustainability score would not be suitable.

Avoiding misuse and greenwashing will require rigorous external monitoring. The question is how this would be coordinated between the EU and member states levels and whether it should be left entirely to public agencies or whether private actors, like the already existing sustainability rating agencies, could also play a role.

4 Create "Sustainable Infrastructure Europe" to channel finance into sustainable projects

<u>Question 4.</u> What key services do you think an entity like "Sustainable Infrastructure Europe" should provide, more specifically in terms of advisory services and connecting public authorities with private investors?

If the purpose of this agency is to promote Public-Private-Partnerships (PPPs) it should be kept in mind that PPPs have a mixed track record with regard to effective and cost-efficient delivery of infrastructure projects. Moreover, the 'mismatch of time horizons' (see Question 5.) between long-term financing needs of the real economy and a financial industry that is overwhelmingly oriented to the short term is especially acute in the case of infrastructure projects, which, by their nature, require very long-term financial commitments and certainty.

Caution is also advised if the proposed 'match-making facility' (p. 44 HLEG Interim Report) is to facilitate *direct* investor involvement in infrastructure projects, e.g. through instruments like project bonds and/or different types of 'blended', i.e. public-private, project finance. Given investors' very strong preference for predictable cash flows from projects, government agencies and public development banks might be tempted or obliged to entice private sector actors through excessive guarantees and risk transfers. This could expose the public budget to excessive fiscal risks.

To sum up, "Sustainable Infrastructure Europe" must not focus just on mitigating the risks for investors, but give equal weight to the fiscal risks associated with public-private arrangements and to the various problems that can result for the general public, such as undue private sector influence on project selection.

5 Mismatched time horizons and short-termism versus long-term orientation

<u>Question 5.</u> It is frequently stated that the inherent short-termism in finance, especially financial markets, represents a distraction from, or even obstacle to, a long-term orientation in economic decision-making, including investments that are essential for sustainability. Do you agree with this statement?

Yes.

<u>Question 5.1.</u> If you agree with this statement, which sectors of the economy and financial system are particularly affected by the 'mismatch of time horizons'? What are possible measures to resolve or attenuate this conflict?

Short-termism is a structural problem that affects all branches of the financial system. To name just two areas:

Mark-to-market accounting for financial instruments transmits the ups and downs of financial markets to the balance sheets and income statements of financial institutions. This, in turn, amplifies and accelerates those ups and downs, in the worst case by forcing financial institutions into unnecessary fire sales. The European Financial Reporting Advisory Group should push for the introduction of less volatile accounting methods for financial instruments and/or adjust the IFRS as adopted by the EU to make less use of mark-to-market accounting.

In banking, short-termism is manifested in a tendency to move away from illiquid loans to non-financial businesses and into, for instance, inter-bank lending, or even a retreat from lending altogether and into proprietary trading and capital market-oriented activities. In other cases, e.g. mortgage lending, loans are liquidated through securitisation with potentially devastating consequences. It is time to ponder a return to 'boring', but long-term, relationship banking, which is more suitable to accompanying the sustainable transformation of the economy than inherently short-term capital market finance. Relationship banking does not serve all businesses equally well, so there will always be a need for market finance. However, expanding market finance, as is the main goal of Capital Markets Union, would be counterproductive.

6 Governance of the investment and analyst community

Question 6. What key levers do you think the EU could use to best align the investment and analyst community with long-term sustainability considerations in the real economy?

According to a recent study by the 2Degrees Investing Initiative there is little demand for long-term analysis from the investor side because their investment horizon is focused on the short-term. On the analyst side, there is certainly also a dearth of appropriate methods and instruments for long-term analyses, but the study's findings suggest that the main lever is to change time frames on the investor side.

One problem are short-term investment mandates and remuneration schemes for asset managers. Asset management firms should provide long-term performance incentives to their managers. At the asset owner level, extant regulation makes many pension fund boards adopt a short-term investment horizon to avoid pension cuts. Regulation should be amended to make it easier for asset owners to incorporate explicit long-term objectives and incentive structures for fund managers in their investment mandates. Generally speaking, long-term active investing, rather than passively following an index, is a better way of managing ESG risks. Asset owners should bring investment mandates for asset management firms in line with such strategies. Regulation could help them by focusing less on reducing the cost of investing, which has pushed pension funds towards passive investing, and by better balancing efficiency and sustainability considerations. Regulators should also consider outright bans on investing in socially and ecologically harmful activities.

7 A strong pipeline of sustainable projects for investment

Question 7. How can the EU best create a strong and visible pipeline of sustainable investment projects ready for investment at scale?

Political leadership counts when the goal is nothing less than economic transformation! A more attractive environment for private sector involvement in sustainable economic activities can be created through strong policies to effect an energy transition and actively pushing the requisite investments, but also through making unsustainable business activities costlier.

A credible and coherent climate policy that coordinates expectations and reduces uncertainty for financial institutions would discourage investment in and loans to firms holding stranded high-carbon assets and boost investment in low-carbon industries. This would reduce the overall economic risk for businesses and investors and create a virtuous circle of additional sustainable investment. The EU's economic governance regime, with its single-minded focus on fiscal

consolidation, is dysfunctional because it hampers the capacities of member states' governments to lead the sustainable transformation of European economies. The EU should modify its ambitious reform agenda for the coming years to increase fiscal policy space accordingly.

Policy-makers should also use more instruments like carbon pricing that force non-financial companies to internalise the social and environmental costs of their activities. This will not only make those activities themselves less profitable, it will also make it less attractive for financial institutions to lend to or invest in them and make sustainable options attractive in comparison.

8 Integrating sustainability and long-term perspectives into credit ratings

Question 8. What are some of the most effective ways to encourage credit rating agencies to take into consideration ESG factors and/or long-term risk factors? (Choose one option from list below.)

- Create a European credit rating agency designed to track long-term sustainability risks
- Require all credit rating agencies to disclose whether and how they consider TCFD-related information in their credit ratings
- Require all credit rating agencies to include ESG factors as part of their rating
- All of the above
- **Other**

Question 8.1 Please specify what other ways you would deem most effective in encouraging credit rating agencies to take into consideration ESG and/or long-term risk factors.

We are doubtful whether the existing commercial rating agencies, or even a newly created European one, can be entrusted with an important role in the transition to a sustainable economy. As organisations they are too deeply rooted in a conventional, i.e. unsustainable and short-term, business logic to do justice to the importance of ESG factors. Moreover, their preference for assigning uni-dimensional scores does not seem appropriate to the multi-dimensional nature of the Sustainable Development Goals. A more promising approach would be to create a new European public agency, or a coordinated system of public agencies at member state level, that assesses ESG risks and assigns certificates to borrowers and financial instruments accordingly.

To be sure, this does not rule out placing additional requirements on the existing commercial rating agencies to include ESG factors in their ratings, but they are not the most important instrument.

9 Role of banks

Question 9. What would be the best way to involve banks more strongly on sustainability, particularly through long-term lending and project finance?

The European Banking Authority (EBA) could use Pillar 2 of the Basel III Accord to require banks to integrate attention to ESG risks to their loan portfolio firmly in their internal risk management systems and to expand the time horizon of risk management. The EBA could learn from countries that have already taken such measures, esp. Bangladesh, Brazil or China. The Brazilian Central Bank,

for example, has provided banks with guidance on how to implement the Internal Capital Adequacy Assessment Process, requiring them to demonstrate how they assess the risk from exposure to social and environmental damage caused by their activities.

Caution is advised regarding proposals to use differentiated risk weights (Pillar 1 of Basel III) to make 'green lending' more attractive. Risk weights should not be used to guide lending to or away from certain sectors for reasons unrelated to financial risks because it would hamper sound risk management. However, inasmuch as advances in environmental legislation and the measuring of carbon-related risks make loan exposure to fossil fuel and similar industries riskier, risk weights could be negatively adjusted ('brown-penalising') for such assets to reflect their true risk.

The EBA could coordinate a ‘carbon stress test’ that involves detailed investigation of corporate loan portfolios and internal risk models used to calculate the capital requirements for such loans. Regulators could further explore the concept of lender liability.

10 Role of insurers

Question 10. What would be the best way to involve insurers more strongly on sustainability, particularly through long-term investment?

Insurers need to understand that their investments influence their business model. Property and damage insurers that invest in carbon intensive industries increase the chance that they will have to pay their insurance clients for damages inflicted by increasingly harmful natural disasters. Likewise, health, life, accident and travel insurers are exposed to more risk if they keep investing in companies (and countries) that neglect workers’ and consumers’ rights. Health and safety regulations are crucial for a sound business model for insurers as less strict regulations and a short-term investment focus mean workers and consumers get injured or sick more often. If insurers invest in companies that are not operating in line with best health and safety practices it will eventually harm their own business model.

The European Insurance and Occupational Pensions Authority (EIOPA) could require insurers to integrate their investment decisions in the risk models they use to make their insurance products profitable. For example: if a property insurer calculates the risk of a recurring flood destroying a house, how does their investment in a coal company, rather than a renewable energy company, affect this risk? EIOPA could further take advantage of the relatively advanced stage of the research on the risks related to insurers’ carbon exposures to conduct a carbon stress test and impose prudential measures if necessary.

11 Social dimensions

Question 11. What do you think should be the priority when mobilising private capital for social dimensions of sustainable development?

1) Private capital can best contribute to social sustainability by paying decent wages that reverse the trend towards a fall in the wage share and increasing inequality. Lenders and investors should screen borrowers and investees for compliance with labour rights standards, but also pay attention to their wage policies and executive remuneration. Financial institutions should amend their internal risk management and due diligence procedures to take wages into account, while regulators should consider supporting such measures by requiring pay ratio disclosures like those

currently being discussed by the UK government and/or by developing new and innovative 'social disclosures'.

2) We regard with scepticism the recommendation to promote the issuance of 'social bonds.' While seemingly attractive from the point of view of the social dimension of sustainability, they are likely to be counterproductive due to their high potential for negative effects on social policy delivery. For example, the need to measure and attribute social policy outcomes to projects, which is difficult at best and impossible at worst, can distort the flow of financing to areas or projects where such measurement is easiest or where success is most likely, regardless of their importance in social policy terms. The most marginalised groups would be marginalised further if private finance were to enter social policy provision in a large scale.

12 Other

Question 12. Do you have any comments on the policy recommendations or policy areas mentioned in the Interim Report but not mentioned in this survey?

We support the HLEG's recommendation that the concept(s) of fiduciary duty for asset managers be extended to encompass sustainability concerns (p. 57 Interim Report). We would like to emphasise in particular that the best interests of the ultimate investors are not served by maximising short-term returns.

We also support Recommendation 4 (pp. 57-8 Interim Report) that disclosure requirements need to be strengthened to enable the financial sector to allocate capital more quickly and efficiently to sustainable economic activities. Important progress has been made with regard to environmental and, specifically, carbon disclosures, but less has happened with regard to the 'S' and 'G' dimensions of ESG disclosures. We see with interest the UK government's plan to introduce mandatory pay ratio disclosures to assess the pay difference between executive officers and average workers.

Question 13. In your view, is there any other area that the expert group should cover in their work?

1) Despite the recent attention given to sustainability issues, the general direction of the Capital Markets Union is at odds with the goal of creating a more sustainable financial system. Increasing the share of capital market financing, as opposed to bank financing, making capital markets more liquid, and encouraging loan securitisation are the opposite of creating a more patient, long-term financial system. The HLEG should not shy away from pointing out such conflicts and insist that sustainability issues take precedence in such cases, as is already envisioned in the notion of a 'sustainability test in financial legislation' (p. 58 Interim Report).

2) The European Central Bank has become a major player on corporate bond markets due to its Corporate Sector Purchase Programme, moving prices on those markets and thus possibly influencing the refinancing conditions for corporate issuers. There is strong concern that these movements are benefitting high-carbon industries and thus counteract political efforts to promote sustainable industries. We do not suggest adding the task of supporting the transition to a sustainable economy to the ECB's mandate – mainly because of the political difficulties of doing so – but neither can its actions be allowed to counteract it. We therefore urge the HLEG to look into

possibilities of amending the ECB's guiding framework accordingly. (See Matikainen, Sini et al. (May 2017), *The climate impact of quantitative easing*, Policy Paper.)