

OCTOBER 2016

# A SUSTAINABLE FINANCE PLAN FOR THE EUROPEAN UNION



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## JOINT INITIATIVE

This document has been developed by E3G as part of a joint initiative with 2 Degrees Investing Initiative, Ario Advisory, Carbon Tracker Initiative, ClientEarth, Climate Bonds Initiative, Climate Disclosure Standards Board, Eurosif, Future-Fit Foundation, Preventable Surprises, ShareAction, the University of Oxford Sustainable Finance Programme and WWF.

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# EXECUTIVE SUMMARY

More than seven years on from the financial crisis, Europe still faces a range of threats including high unemployment, social inequality and high levels of public debt. Questions are being asked about whether Europe will still be able to shape economic, social and environmental standards for the rest of the world and whether and when its economy will finally recover. Continued low levels of investment in the European Union (EU) have limited employment opportunities and the scope for sustainable development. In turn, this has led to a weakening of social cohesion and investor confidence, with the knock-on effect that the EU now faces a pension fund deficit estimated at €428bn.

Facing these issues head on and placing the need to respond to Europe's social but also environmental problems at the heart of the economic solutions proposed will be important for success. It is by identifying responses to Europe's social and environmental problems that the European Commission can do most to reverse the EU's fortunes.

Recognising this, the European Commission has announced two new proposals. First, to double the financial capacity and duration of the European Fund for Strategic Investment (EFSI) to provide at least €500 billion of investments by 2020: of which at least 40% will be dedicated to climate action. Second, it announced a Capital Market Union (CMU) refresh – including the establishment of an expert group to develop a comprehensive strategy on sustainable finance. This is welcome.

This report outlines a 'Sustainable Finance Plan 2030' that focuses on three key aims and objectives that should be central to the Commission's strategy on sustainable finance. First, the Commission should focus on increasing investment in sustainable infrastructure. It should use the current infrastructure investment gap as an opportunity to boost development and employment opportunities, shore up investor confidence in the European project, and put the EU on a pathway to sustained economic recovery whilst managing climate risk. Second, it should look for opportunities to increase responsible investment practices. The need to address social and environmental problems should be at the heart of the financial reform agenda to enable sustainable growth. Third, the Commission should improve climate risk disclosures. Good governance and better information can help improve corporate accountability, an enabler of inclusive prosperity. Eight priority actions are recommended to take this forward.

## SUSTAINABLE INFRASTRUCTURE

- > **Recommendation 1:** The Sustainable Finance Plan 2030 should explicitly link the CMU and Investment Plan to the Energy Union, by asking Member States to develop National Capital Raising Plans as part of their National Energy and Climate Plans (NECPs). This would make sustainable investment opportunities more visible to the private sector and increase investor confidence in the NECPs.
- > **Recommendation 2:** To effectively crowd in private capital, the Sustainable Finance Plan 2030 should ensure that all European financial public sector risk-sharing tools (e.g. the EFSI and Project Bonds Initiative but also grants and financial instruments developed under the wider Multiannual Financial Framework) are fully aligned with the EU's climate targets.
- > **Recommendation 3:** The European Commission should support the rapid development of robust, fully developed and widely accepted industry standards for green bonds. Following that it should use its convening power to stimulate debate with Member State governments on the role of fiscal policy in promoting the green bond market.

## RESPONSIBLE INVESTMENT

- > **Recommendation 4:** The European Commission should end the debate on environmental, social and governance (ESG) risk in the context of fiduciary duty as soon as possible. It should provide guidance to the competent Member State authorities on how they should interpret fiduciary duty in the national legal context. This guidance should clarify that asset owners have a duty to pay attention to long term factors including ESG factors where they are likely to be financially material. Authorities should also clarify that assets 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.
- > **Recommendation 5:** The European Commission should develop legislative proposals to require asset owners to consult their beneficiaries on their attitude to and preference (or not) for having their money invested sustainably. Such a proposal would improve accountability in the investment system and build trust in financial services as a force for good.
- > **Recommendation 6:** The European Commission should improve transparency around responsible investment by proposing mandatory requirements for all asset owners to disclose information about their responsible investment policies and the implementation of those policies. This should result in the asset owners' service providers (asset managers, investment

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1. The term non-financial information is a misnomer as it can refer to information that is, in fact, financially material. We use the phrase 'so-called non-financial' in this report.

consultants etc.) providing the information and advice their clients need, for example so-called non-financial<sup>1</sup> performance factors, engagement activities (including voting decisions) and their overall impact.

- > **Recommendation 7:** The European Commission should support the development of green finance benchmarks that measure portfolio alignment with climate targets. It should then recommend that Member State prudential regulators adopt regulation that asks financial institutions to disclose whether their activities align with scenarios that keep global temperature increases to below 2°C and also 1.5°C using these benchmarks.

## CLIMATE RISK DISCLOSURES

- > **Recommendation 8:** The European Commission should incorporate into the mandate of the new expert group on sustainable finance an early focus on how recommendations from the Financial Stability Board's Task Force on Climate-related Financial Disclosures can be best assimilated into the EU's existing reporting framework. It should also consider two other issues: through what means decision-useful reporting can be best enforced to enable regulators at a national and EU level to fully understand the financial systems' exposure to climate risk; and the need to move beyond reporting of risk to how companies intend to take action and report on efforts to mitigate those risks.

# INDICATIVE POLICY ROADMAP

2016

2017

2018



Sustainable  
infrastructure

Ask Member States to develop capital raising strategies as part of National Climate and Energy Plan. *Recommendation 1, Page 13*

Stimulate debate with Member State governments on the role of fiscal policy in promoting the green bond market. *Recommendation 3, Page 15*

Support the rapid development of robust, fully-developed and widely-accepted industry standards for green bonds. *Recommendation 3, Page 15*

Ensure public sector risk sharing tools (e.g. EFSI, Project Bonds Initiative) are fully aligned with the EU's climate change targets. *Recommendation 2, Page 14*



Responsible  
investment

Ensure a requirement for investors to disclose their responsible investment policies is included in the Shareholder Rights Directive. *Recommendation 6, Page 24*

Require asset owners to consult their beneficiaries on their attitude and preference (or not) for responsible investment policies. *Recommendation 5, Page 23*

Provide guidance on fiduciary duties to clarify that ESG factors can and should be included in investment decision-making. *Recommendation 4, Page 22*

Support the development of green finance benchmarks that measure financial portfolios alignment with climate targets. *Recommendation 7, Page 15*



Climate risk  
disclosure

Ensure existing EU legislation on risk reporting is properly monitored and enforced. *Recommendation 8, Page 33*

Develop plans to assimilate the forthcoming recommendations of the FSB's Taskforce for Climate-related Financial Disclosures. *Recommendation 8, Page 33*

FSB taskforce  
recommendations  
published

CMU mid-term  
review

Non-Financial Reporting  
Directive review

European Commission

EIB

European Parliament

ESMA



# THE POLITICAL CONTEXT

*In his September 2016 State of the Union speech, President Juncker spoke about the range of continued threats Europe faces. Among other issues he drew attention to high unemployment, social inequality and high levels of public debt. He noted that, more than seven years on from the financial crisis, questions are still being asked about whether Europe will still be able to shape economic, social and environmental standards for the world and whether its economy will finally recover or be stuck in low growth and low inflation for the next decade. His conclusion was that Europeans want concrete solutions to the very pertinent problems that the Union is facing. And they want more than promises, resolutions and summit conclusions.*

One of first core objectives established by the European Commission in 2014 was to increase investment to generate jobs to put the European Union (EU) on the path to sustained economic recovery. The Capital Markets Union Initiative (CMU) was launched with these aims in mind. Its focus is on mobilising private capital and channelling it to the small and medium sized businesses that need capital to expand and to the infrastructure projects that support the economy, create jobs and boost European competitiveness. The CMU has delivered some positive outcomes, such as the changes to Solvency II regulation that make it easier for insurance companies to invest in infrastructure. Its sister initiative, the European Fund for Strategic Investment (EFSI) has catalysed € 138bn in public and private investment since its inception in 2015. However despite these efforts, investment levels in the EU remain significantly below their pre-crisis peak. Low levels of investment have limited the expansion of European employment opportunities and sustainable development. In turn, this has led to a weakening in social cohesion and investor confidence, with the knock-on effect that the EU now faces an estimated pension fund deficit of at least €428bn<sup>2</sup>. Finding a way to break out of this negative spiral will be vital to rebuild prosperity and confidence in the European project.

Facing these issues head on and placing the need to respond to Europe's social and also environmental problems at the heart of the economic solutions proposed will be vital to deliver the solutions Europeans want. Recognising this, the European Commission has announced two new proposals. First, it will double the financial capacity and duration of the EFSI. It will now mobilise at

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2. EIOPA (2016) **First EU Stress Test for Occupational Pensions**



least €500 billion of investments by 2020 and a minimum of 40% of projects will be dedicated to climate action<sup>3</sup>. Second, it announced a CMU refresh – including the establishment of an expert group to develop a comprehensive strategy on sustainable finance<sup>4</sup>.

These announcements are welcome. It is by identifying responses to Europe’s social and environmental problems that the European Commission can do most to reverse the EU’s fortunes. This report sets out how the European Commission can take its work to develop a strategy on sustainable finance forward; what the key aims and objectives should be; and proposals for how to achieve them. It is structured around three key elements:

- > **Sustainable infrastructure:** The Commission should use the current infrastructure investment gap as an opportunity to boost development and employment opportunities, shore up investor confidence in the European project, and put the EU on a pathway to sustained economic recovery whilst managing climate risks;
- > **Responsible investment:** The need to address social and environmental problems should be placed at the heart of financial reforms to drive sustainable growth. Promoting more responsible investor behaviour can help achieve that.
- > **Climate risk disclosures:** Better information can help ensure good governance whilst properly pricing capital.

Eight priority actions are recommended, which are summarised on page 7.

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3. European Commission (2016) **State of the Union 2016: The European Fund for Strategic Investments (EFSI) - Frequently Asked Questions**

4. European Commission (2016) **Capital Markets Union - Accelerating Reform**

# CHAPTER 1

## SUSTAINABLE INFRASTRUCTURE: MAKING A VIRTUE OF NECESSITY

*The first objective of the Sustainable Finance Plan 2030 should be to turn the current infrastructure investment gap from a threat to an opportunity. Substantially more private sector investment is needed to bridge the gap between current levels of investment in infrastructure and that required to meet the demands of the future. For instance, the investment gap in the energy sector is estimated to be €100bn per year. Two major barriers preventing the closure of this gap are a limited supply of attractive investment opportunities and a lack of access to finance for some projects. The removal of these barriers should be a major focus of the Plan. Doing so will boost development and employment opportunities, shore up investor confidence in the European project and put the EU on a pathway to economic recovery. It will also drive sustainable development and ensure the EU meets its 2030 climate targets.*

The Sustainable Finance Plan 2030 should make a virtue of necessity and link the Investment Plan for Europe, the Capital Markets Union (CMU) and the Energy Union initiatives. Doing so would benefit all three. The Energy Union can help to provide a pipeline of projects to boost investment and the Investment Plan and CMU initiatives can help projects access finance<sup>5</sup>. Developing a strong forward pipeline of infrastructure assets would help to close the looming and substantial pension fund deficit in the EU. European Insurance and Occupational Pensions Authority (EIOPA) data suggest that this is at least €428bn, equal to ~2.5% of EU GDP<sup>6</sup>.

### THE EU IS UNDER-INVESTING IN SUSTAINABLE ENERGY INFRASTRUCTURE

*“The European Investment Bank has estimated a gap of €100bn per year to deliver an Energy Union in line with the EU’s 2030 climate and energy targets”*

5. E3G (2016) **Clean Energy Lift Off: Capitalising on Europe’s Energy Union**

6. EIOPA (2016) **First EU Stress Test for Occupational Pensions** Note: the €428bn refers to the total deficit as measured by the EIOPA common methodology, pre-stress on 31 December 2014. The EIOPA stress test covers pension funds in 17 Member States and does not have full coverage. As a result, the true deficit size is likely to be significantly larger.

Energy infrastructure investment is a particular concern. The European Investment Bank (EIB) has estimated a gap of €100bn per year to deliver an Energy Union in line with the EU's 2030 climate and energy targets (Table 1)<sup>7</sup>. Data from Bloomberg New Energy Finance show a downward investment trend over the past five years: in 2015 clean energy investment in the EU was two-thirds below its 2011 peak (Figure 2). By comparison, investment levels in emerging economies such as China have increased rapidly: China is now investing more than twice as much as the EU and a similar amount per capita. Europe has traditionally been a leader in clean energy technologies. As such, the growth of the Chinese investment poses a threat to the competitiveness of the EU renewables industry<sup>8</sup>.

The green economy already employs around 1 million people in the EU<sup>9</sup>. Increasing the level of investment in clean energy infrastructure will not only help the EU deliver its greenhouse gas emission reduction targets but could also provide a substantial number of new high quality jobs in the green economy. For example, a recent study by Cambridge Econometrics for the European Commission has found that delivering a 30% energy efficiency target by 2030 alone could provide as many as 4.2 million jobs over that period or 1.9% of total employment in the EU<sup>10</sup>. Since energy efficiency improvements are required across countries and sectors, the jobs would be created throughout the EU. For this job creation to happen, investment levels in energy efficiency must increase – the EIB cites an annual investment gap of €70bn per year in energy efficiency alone (Table 1). Boosting 2030 target compatible investment in power generation and energy networks would create further additional employment.

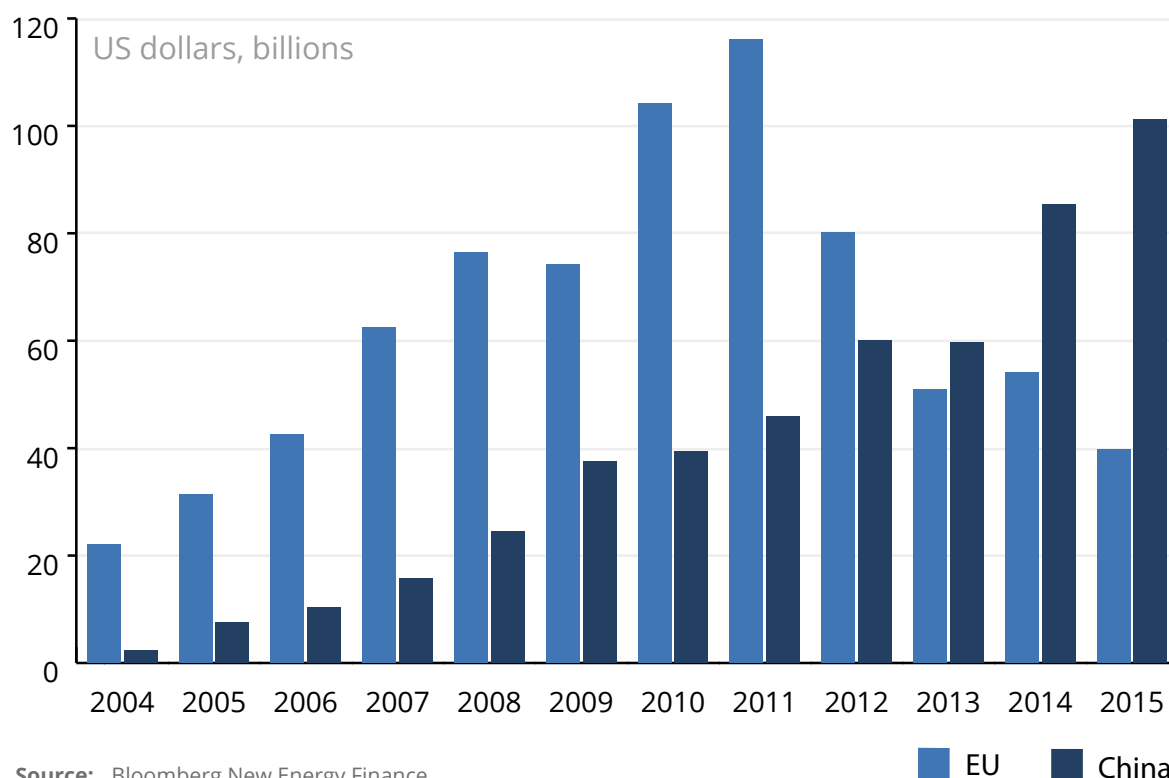
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7. EIB (2016) **Restoring EU competitiveness**

8. E3G (2016) **Pulling ahead on clean technology: China's 13th Five year plan challenges Europe's Low Carbon Competitiveness**

9. <https://www.theparliamentmagazine.eu/articles/opinion/green-economy-now-reality-europe>

10. Cambridge Econometrics (2015) **Assessing the Employment and Social Impact of Energy Efficiency** The study models the impact of energy efficiency on the economy and finds that delivering a 30% energy efficiency target would provide 0.7m to 4.2m jobs across the EU cumulatively to 2030.

**FIGURE 2: CLEAN ENERGY INVESTMENT IN THE EUROPEAN UNION AND CHINA**

**TABLE 1: INVESTMENT NEEDS IN THE ENERGY SECTOR**

Investment need/objective	Annual investment (€bn)		
	Required <sup>11</sup>	Current <sup>12</sup>	Gap
Upgrading energy networks (gas and electricity)	64	47	18
Energy efficiency savings in buildings and industry	112	42	70
Power generation, including renewables	53	41	12
<b>Total</b>	<b>230</b>	<b>130</b>	<b>€ 100bn</b>

Source: European Investment Bank

11. European Commission estimates of average annual investment in EU28 over the period 2016 to 2030, supplemented on occasion by EIB estimates. The scenario assumes compliance with all existing EU legislation, plus adoption of a 40% GHG target by 2030.

12. European Commission estimates of average annual investment in EU28 over the period 2001 to 2015, supplemented on occasion by EIB estimates.

## LIFT THE BARRIERS TO PRIVATE SECTOR INVESTMENT

Investing in sustainable energy infrastructure, including energy efficiency, can either be delivered using publicly or privately sourced finance. Financing infrastructure has arguably never been cheaper than it is today. Around one-third of developed economy government bonds are yielding below zero. So, where financing can be provided publically, it should be considered. That said, ongoing concerns about levels of public sector debt in many Member States are likely to limit this option, and so the private sector will need to play a major role in providing capital for investment.

*“A recent survey by the OECD found that pension funds are willing to invest more in infrastructure than they currently do ... [but] Member States are not producing a reliable pipeline of investable opportunities”*

Globally, it is estimated that \$90 trillion of infrastructure investment is required to 2030, with the expectation that 80% of this will come from the private sector including institutional investors<sup>13</sup>. These investors are willing to invest more in infrastructure, which is increasingly considered the bedrock of a healthy portfolio<sup>14</sup>. A recent survey by the OECD found that pension funds would like to invest more in infrastructure than they currently do<sup>15</sup>. Increased investment in infrastructure makes sense for pension funds because it offers reliable long-term returns, which are especially important in the context of widening pension deficits across the EU: EIOPA figures suggest the EU pension fund deficit is at least €428bn<sup>16</sup>. As a result, institutional investors’ appetite for infrastructure assets is unlikely to diminish, especially while interest rates on government bonds and other more traditional assets remain at historically low levels.

To increase private sector investment to the levels required, two major barriers need to be addressed. The first is, simply, that there are not enough energy infrastructure projects available to invest in. Member States are not producing a reliable pipeline of investable opportunities, a problem compounded by the significant concerns about risk of policy changes<sup>17, 18</sup>.

Part of the solution is for Member States to take a forward looking view of their infrastructure needs and create a plan to attract investment. The Energy Union initiative already asks Member States to publish National Energy and Climate Plans (NECPs). This is welcomed – clear objectives and strategic planning is essential to build confidence within the investment community that

13. New Climate Economy (2015) **Infrastructure Investment needs of a low-carbon scenario**

14. Private discussions with asset managers

15. OECD (2015) **Annual survey of large pension funds and public pension reserve funds**

16. EIOPA (2016) **First EU Stress Test for Occupational Pensions**

17. OECD (2015) **Annual survey of large pension funds and public pension reserve funds**

18. Diacore (2016) **The impact of risks in renewable energy investments and the role of smart policies**

the EU is serious about meeting its long term climate and energy targets. The NECPs should set out how public capital and market reforms will be used to crowd in private capital and deliver EU infrastructure needs. Doing so would be in line with the recommendation of the G20 Green Finance Study Group to ‘provide strategic policy signals and frameworks’ for investors<sup>19</sup>. It is recommended that:

- > **Recommendation:** The Sustainable Finance Plan 2030 should explicitly link the CMU and Investment Plan to the Energy Union, by asking for Member States to develop National Capital Raising Plans as part of their NECPs. This would make sustainable investment opportunities more visible to the private sector and increase investor confidence in the NECPs.

*“There needs to be a more explicit alignment of the EIB’s activities and the wider focus of EU budget allocations under the Multiannual-Financial Framework to meet the EU’s climate objectives and close the infrastructure investment gap”*

In addition, investments in sustainable energy infrastructure need to be made more attractive to private sector investors. Often, sustainable infrastructure assets are perceived to be risky relative to other, similar, investments<sup>20</sup>. This can be due to technology innovation or policy risk, for example concerns that renewable policy schemes in Member States will be changed or cancelled at short notice<sup>21</sup>. This can be partially resolved by creating public-private risk sharing with public banks, such as the EIB. EIB risk sharing tools including the European Fund for Strategic Investment (EFSI) and the Project Bonds Initiative have been successful in making such investments more attractive and consequently have mobilised significant private sector capital into low carbon projects<sup>22</sup>. There is also a strong forward focus on increasing the pipeline of energy efficiency projects<sup>23</sup>. Nevertheless, there needs to be a more explicit alignment of the EIB’s activities and the wider focus of EU budget allocations under the Multiannual-Financial Framework (MFF) to meet the EU’s climate objectives and close the infrastructure investment gap<sup>24</sup>. As such, it is recommended that:

- > **Recommendation:** To effectively crowd in private capital, the Sustainable Finance Plan 2030 should ensure that all European financial public sector risk sharing tools (e.g. EFSI and Project Bonds

19. G20 Green Finance Study Group (2016) **G20 Green Finance Synthesis Report**

20. Ecofys (2011) [https://ec.europa.eu/energy/sites/ener/files/documents/2011\\_financing\\_renewable.pdf](https://ec.europa.eu/energy/sites/ener/files/documents/2011_financing_renewable.pdf)

21. Diacore (2016) **The impact of risks in renewable energy investments and the role of smart policies**

22. €105bn of private sector capital has been mobilised by EFSI to September 2017

23. For details about the European Fund for Strategic Investment see: <http://www.eib.org/efsi/>. For details about the **Project Bonds Initiative** see: <http://www.eib.org/products/blending/project-bonds/>

24. Jacques Delors Institute (2016) **Investment In Europe: Making The Best Of The Juncker Plan With Case Studies On Digital Infrastructure And Energy Efficiency**

Initiative but also grants and financial instruments developed under the wider MFF) are fully aligned with the EU's climate targets.

## GREEN BONDS

To scale up investment in low-carbon infrastructure across the economy, bond financing will be an important tool<sup>25</sup>. The European Commission is in the process of producing a study on the potential of the bond market to boost the volume of capital available for projects that drive the transition towards a sustainable economy and is looking at potential policy options<sup>26</sup>.

In line with the recommendations of the G20 Green Finance Study Group synthesis report, the European Commission should support the development of robust, fully-developed and widely-accepted industry standards<sup>27</sup> for the green bond market as soon as possible to speed up the process of commoditisation of the market, to provide guidance for issuers and to avoid the risk of 'greenwashing' – bonds that do not fulfil their green promises – which could halt further growth of the market by undermining its credibility<sup>28</sup>.

*“In order to get from niche to mainstream, [green bonds] will need policy support”*

-Antonio Simoes, CEO HSBC

The green bond market remains small – green bonds are estimated to constitute less than 1% of the overall global bond market<sup>29</sup>. If the European Commission is serious about using the green bond market as a tool to drive the transition to a low carbon economy, measures will need to be taken to accelerate market growth. Guidance around validation and certification of green bonds would help further boost investor appetite. The costs associated with these practices (estimated at between \$15-30k for certification, up to \$100k for bespoke reviews) may be a barrier for small issuers, but these costs frictions decline as scale and market awareness increase and as standardisation and commoditisation of the green review and reporting process becomes the norm<sup>30</sup>. Financial incentives may also be needed to scale up the market at the required pace and stimulate increased issuance of certified corporate green bonds<sup>31</sup>. Such incentives could help shift issuers preferences by changing the

25. Climate Bonds Initiative (2016) **Bonds And Climate Change: The State Of The Market In 2016**

26. European Commission (2016) **Capital Markets Union: First Status Report**

27. G20 Green Finance Study Group (2016) **G20 Green Finance Synthesis Report**

28. WWF (2016) **Green bonds must keep the green promise!**

29. G20 Green Finance Study Group (2016) **G20 Green Finance Synthesis Report**

30. G20 Green Finance Study Group (2016) **G20 Green Finance Synthesis Report**

31. See [https://www.responsible-investor.com/article/hsbcs\\_uk\\_europe\\_ceo\\_green\\_bond/](https://www.responsible-investor.com/article/hsbcs_uk_europe_ceo_green_bond/) and [https://www.responsible-investor.com/article/tax\\_breaks\\_could\\_be\\_the\\_catalyst/](https://www.responsible-investor.com/article/tax_breaks_could_be_the_catalyst/)



relative prices of 'green' versus 'brown' activity, which in turn would help to accelerate the transition to a low carbon and resource efficient economy. As such the European Commission should consider the role the Sustainable Finance Plan can play in facilitating this debate in Member States.

> **Recommendation:** The European Commission should support the rapid development of robust, fully developed and widely accepted industry standards for green bonds. Following that it should use its convening power to stimulate debate with Member State governments on the role of fiscal policy in promoting the green bond market.

# CHAPTER 2

## RESPONSIBLE INVESTMENT: ADDRESSING SUSTAINABILITY CHALLENGES THROUGH FINANCIAL REFORM

***For the first time there is a real possibility that Europe's youth will earn less and face a worse quality of life than their parents and grandparents. High unemployment and rising social inequality in Europe are a fact of life, as are growing concerns that Europe is falling behind in shaping economic, social and environmental standards for the world. But they should not and do not need to be. The second objective of the Sustainable Finance Plan 2030 should be to use financial service reforms to address social and environmental problems by promoting responsible investment across the EU. The Sustainable Finance Plan should recognise and leverage the fact that the financial sector can help to tackle social issues like unemployment and inequality and environmental issues like climate change. To help meet the aims of the Paris Agreement and the UN Sustainable Development Goals (SDGs), policies should be developed within the CMU that explicitly focus on promoting responsible investment practices and a transparent and accountable financial system with incentives aligned from investor to final beneficiary.***

To achieve this, the Sustainable Finance Plan 2030 should initially focus on making it easier for, and encouraging, private investors to invest responsibly. There are a number of perceived barriers that targeted EU policy can help to remove. Doing so will ensure interests are aligned throughout the investment chain by providing clarity to investors on how they can and should use environmental, social and governance (ESG) information to ensure they are investing in the best interests of their beneficiaries and society.

To achieve this, the Plan should:

- > Provide confirmation to asset owners that incorporating information related to ESG factors into investment decisions is part of their fiduciary duty<sup>32</sup>.
- > Create greater accountability among asset owners by ensuring that beneficiaries have a say in how their money is invested.

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32. It is often argued that investors do not have sufficiently granular or comparable information to fully integrate ESG information into how capital is priced and allocated. Improving the quality and consistency of company disclosures is vital to address this and is covered in detail in Chapter 3.

- > Improve transparency and choice for beneficiaries by requiring all asset owners to publish information about their responsible investment practices.

*“The Sustainable Finance Plan should recognise and leverage the fact that the financial sector can help to tackle social issues such as unemployment and inequality and environmental issues like climate change”*

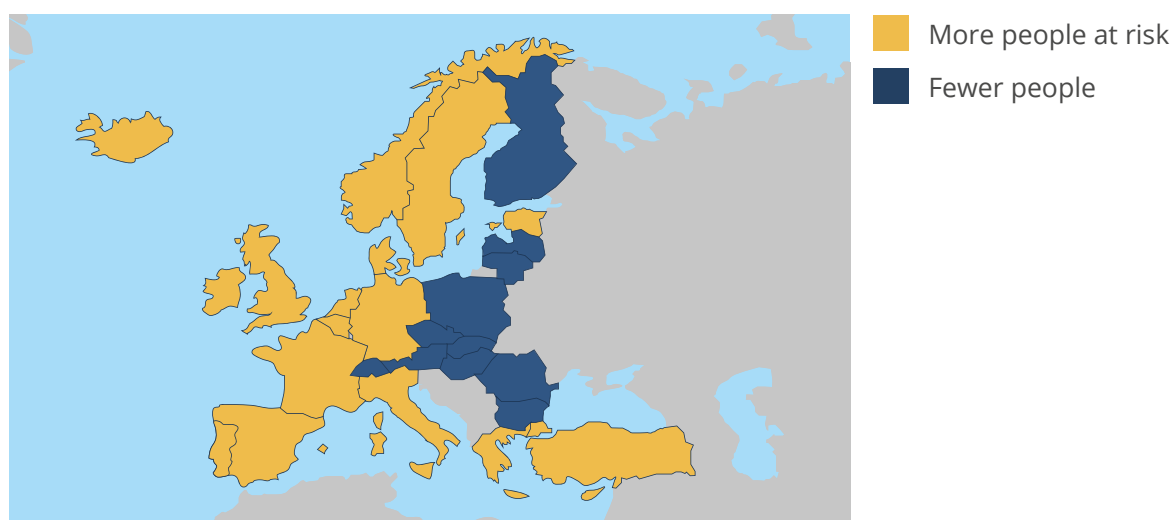
## THE EU FACES SIGNIFICANT SOCIAL AND ENVIRONMENTAL CHALLENGES

The vote by the United Kingdom to leave the EU has highlighted significant issues with trust and social cohesion in many Member States. As some commentators have pointed out, many European citizens have limited opportunities of education, work, access to power and life expectancy at the same time as the proportion of total income that goes to the highest earners has increased. The lack of voice and opportunity for those at the bottom in conjunction with rising incomes of the wealthiest is not unique to the UK. There are 122 million people at risk from social exclusion in the EU, 4.6 million more than in 2008 (Figure 3). At the same time, the income share taken by the top 1% of earners has increased substantially over the past few decades (Figure 4).

*“When such a large group in the population gains so little from economic growth, the social fabric frays and trust in institutions is weakened”*

-OECD

**FIGURE 3: PEOPLE AT RISK FROM SOCIAL EXCLUSION, CUMULATIVE CHANGE SINCE 2008**

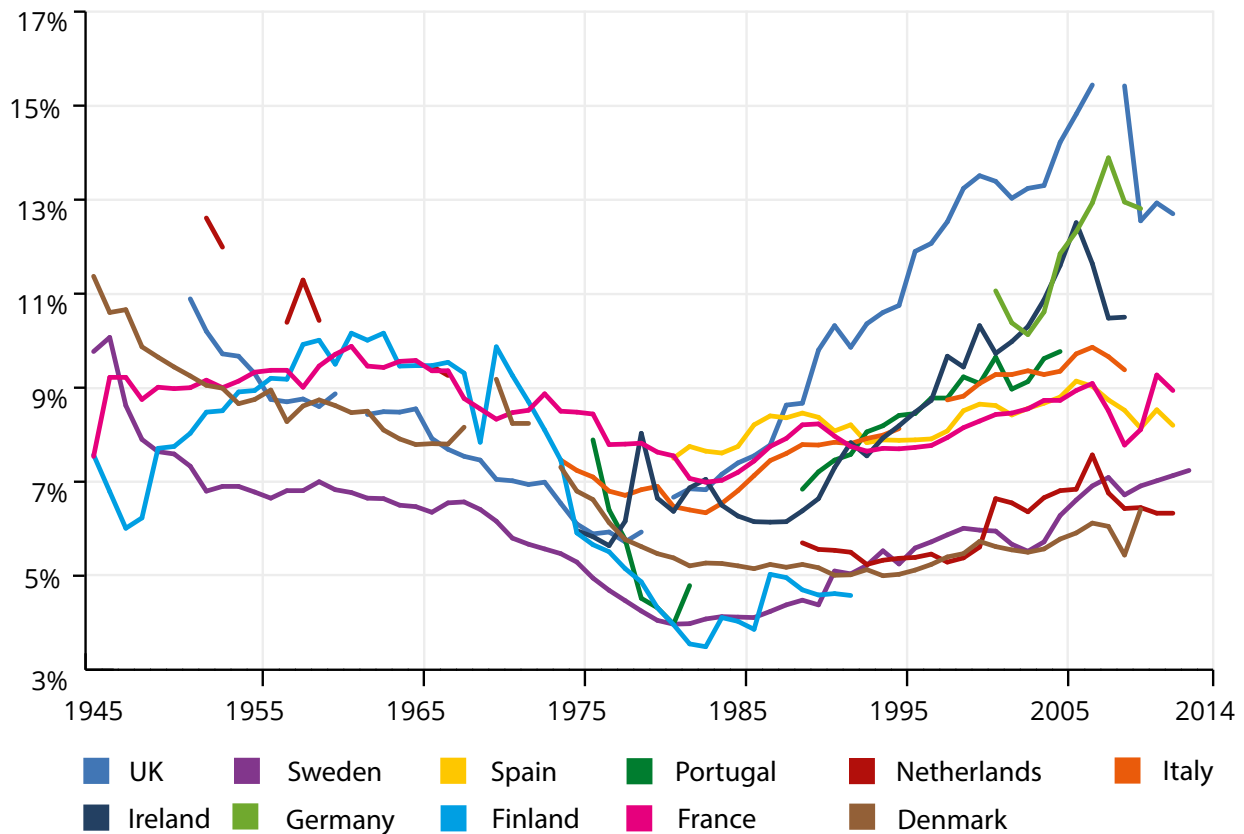


Source: Bloomberg New Energy Finance

These social trends are likely to have contributed to growing dissatisfaction with the status quo and the institutions that maintain it. A recent OECD report on inequality concludes – “when such a large group in the population gains so little from economic growth, the social fabric frays and trust in institutions is weakened”<sup>33</sup>. During the last decade the proportion of people that have a favourable view of the EU has fallen significantly (Figure 5). Despite some improvement in recent years, trust in the financial sector remains at historically low levels<sup>34</sup>.

*“The expected permanent value loss to global assets from climate change has been estimated as €3.8 trillion in present value terms – equal to the GDP of Japan”*

**FIGURE 4: THE INCOME SHARE OF THE TOP 1%, PER CENT**



**Source:** The World Wealth and Income Database

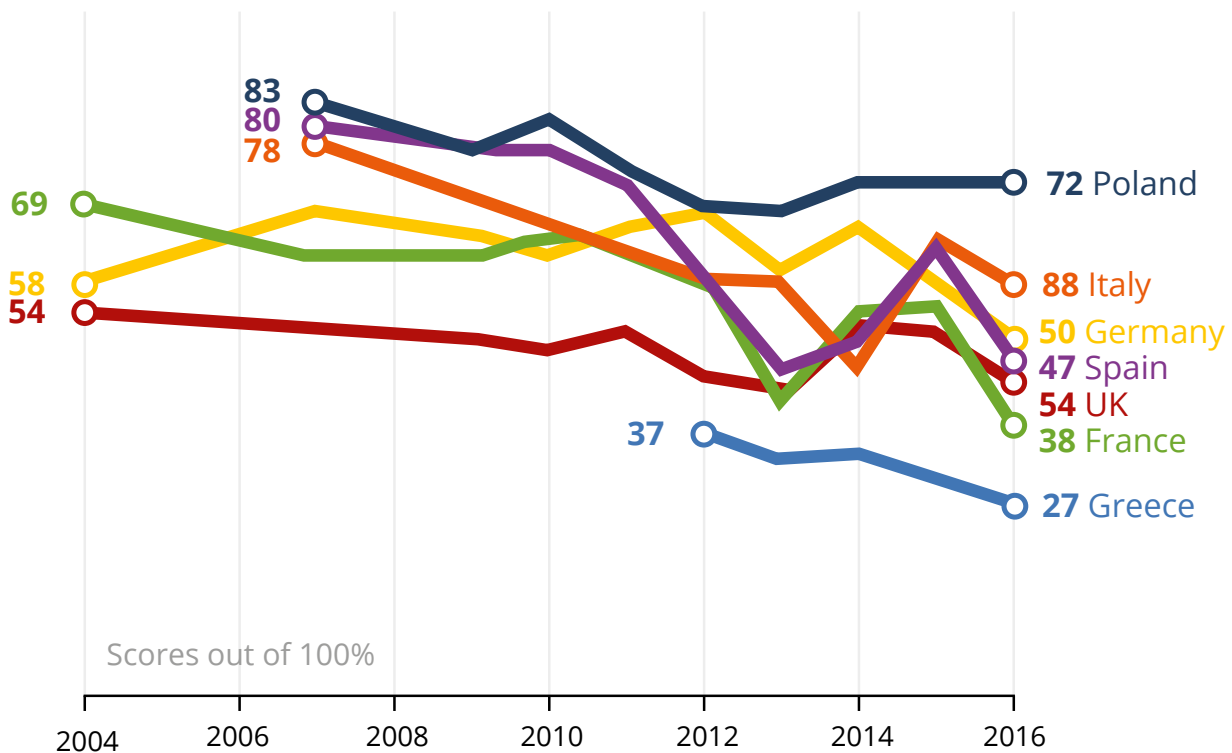
**Note:** The measurement technique used to calculate top incomes changed in Denmark (1970) Finland (1993) and UK (1990)

33. OECD (2015) *In It Together: Why Less Inequality Benefits All*

34. Edelman (2016) *Global Trust in Financial Services*

There are also significant environmental issues that need to be addressed. The largest of these in terms of financial value at risk and potential social impacts is climate change<sup>35</sup>. For example, the expected permanent value loss to global assets from climate change has been estimated as €3.8 trillion in present value terms – equal to the GDP of Japan. Climate change is likely to create substantial instability across the global economy<sup>36</sup>. Financial losses from climate change are not limited to one sector of the economy – it will have a negative impact on economic growth and infrastructure<sup>37</sup> so all sectors of the economy will be affected. As a result, climate change has been called “an unhedgeable risk”<sup>38</sup>.

**FIGURE 5: PROPORTION OF RESPONDENTS WITH A FAVOURABLE VIEW OF THE EU**



Source: Pew Research Centre

35. Ecological imbalances are at unprecedented levels and their impacts are increasingly unpredictable, sudden tipping points and feedback loops could create irreversible change. IPCC (2014) **Fifth Assessment Report**. Human activity has pushed the planet over three of the nine interlinked ‘planetary boundaries’ Rockström et al. (2009) **A Safe Operating Space for Humanity**

36. The Economist Intelligence Unit (2015) **The cost of inaction: Recognising the value at risk from climate change**

37. European Commission (2016) **Resilience of large investments and critical infrastructures in Europe to climate change**

38. University of Cambridge: Institute for Sustainable Leadership (2015) **Unhedgeable risk: How climate change sentiment impacts investment**

## PROMOTING RESPONSIBLE INVESTMENT PRACTICES AS A SOLUTION

These social and environmental problems present significant challenges to ensuring enduring European prosperity and stability. Implementing policies that promote responsible investment practices can help address these issues and ensure that the financial sector plays its part in supporting sustainable and inclusive growth in Europe<sup>39</sup>. This means a greater focus on promoting good governance, greater transparency and accountability and an alignment of incentives between the users of capital (companies), the providers of capital (savers and beneficiaries) and the investment chain that connects the two. This ultimately makes the investment system more accountable and acts in savers and society's long-term interests<sup>40</sup>.

A responsible approach to investment can support sustainable development in two ways. First, the integration of ESG factors into investment decision-making can lead to capital reallocations towards companies that perform well on ESG criteria and away from companies that perform less well. The degree to which this occurs will depend on the extent of ESG integration and whether or not the investor explicitly attempts to have a positive impact (see Box 1). French asset manager Mirova provides an example of the latter. It has funds that support job creation in Europe by channelling finance to areas that would otherwise not be able to access it<sup>41</sup>. In general, whilst this activity will lead to some reallocations of capital, unless all investors act in this way it is likely to have a limited overall impact on the ability of unsustainable companies to access capital<sup>42</sup>.

### BOX 1: WHAT IS RESPONSIBLE INVESTMENT?<sup>43</sup>

Responsible investment, as defined by the Principles for Responsible Investment (PRI), is an approach to investing that incorporates ESG factors into investment decisions to better manage risk and generate sustainable long-term returns. Responsible investors recognise that ESG factors present risks and opportunities that can have a material effect on returns. Incorporating ESG factors into investment decisions means bringing additional data and analysis into existing investment approaches. It does not necessitate the use of specialised products such as themed funds or green bonds.

There are many ESG factors that could be incorporated into investment decisions. Environmental factors include issues such as climate change, resource depletion and waste and pollution. Social

39. As Commissioner Dombrovskis called for in his **speech at the Eurofi Financial Forum 2016, Bratislava**

40. ShareAction (2016) **A Manifesto for Responsible Investment**

41. For example their **euro sustainable fund** aims to support job creation in Europe

42. A theoretical explanation for why this is the case in the context of the fossil fuel divestment campaign is provided in "Stranded assets and the fossil fuel divestment campaign: what does divestment mean for the valuation of fossil fuel assets?" <http://www.smithschool.ox.ac.uk/research-programmes/stranded-assets/SAP-divestment-report-final.pdf>

43. Source: **UN Principles for Responsible Investment**

factors include working conditions, local communities and employee relations. Whilst governance factors include executive pay, board diversity and structure and bribery and corruption issues.

There are other investment strategies that have similarities with responsible investment but remain different – typically because they prioritise ESG factors over pure financial returns. These strategies include socially responsible investing, impact investing and sustainability themed investment.

In addition to incorporating ESG issues into traditional investment decision-making, PRI members make an equivalently important commitment to being “active owners and incorporate ESG issues into our ownership policies and practice”.

For this reason, investor engagement with (stewardship of) companies – the second channel through which responsible investment can support sustainable development – is vital. Stewardship refers to the activities undertaken by institutional shareholders (usually the asset managers) to monitor, engage and intervene on matters that may affect the long-term value of investee companies. Such matters include strategy, performance, corporate governance, and environmental and social issues that may materially affect the future sustainability of companies and shareholder value. Just 80 companies are responsible for over 50% of global greenhouse gas emissions<sup>44</sup> – so investor stewardship can help encourage these companies towards more sustainable business practices. For example in the past couple of years, investor pressure has led to shareholder resolutions requiring fossil fuel and mining companies to publish business transition plans that are consistent with a 2°C world<sup>45</sup>, many of these passed with close to unanimous support in Europe and received around two-fifths of the vote in the US.

*“Responsible investment ... covers only 11% of the overall EU fund management industry.”*

Responsible investment strategies have grown quickly in recent years as forward-thinking investors understand the need for a more inclusive approach to investment. Despite this growth, the total assets under ‘responsible management’ are a relatively small proportion of the overall European fund management industry. For instance, responsible investment as defined by the Principles for Responsible Investment (PRI) (see Box 1) covers only 11% of the overall EU fund management industry. Other investment strategies that explicitly try to have a positive social and/or environmental impact – rather than simply integrating ESG factors into investment decision making – are smaller still (Table 2).

44. BlackRock (2016) **Adapting portfolios to climate change**

45. ‘Aiming for A’ climate change resolution overwhelmingly approved by Glencore shareholders



**TABLE 2: INTEGRATION OF DIFFERENT RESPONSIBLE INVESTMENT STRATEGIES BY EUROPEAN FUND MANAGERS**

Investment strategy <sup>46</sup>	2013 ( €bn)	% overall assets
ESG negative screening	6,900	41.1
Norms based screening	3,600	21.4
Engagement	3,300	19.6
ESG integration	1,900	11.3
ESG positive screening	350	2.1
Sustainability themed	59	0.4
Impact investing	20	0.1
<b>EU investment fund industry</b>	<b>16,800</b>	<b>100</b>

Source: Eurosif<sup>47</sup>

46. ESG negative screening: an approach that excludes specific investments.

Norms-based screening: Screening of investments according to their compliance with international standards and norms.

Engagement: Engagement activities and active ownership through voting of shares and engagement with companies on ESG matters. This is a long-term process, seeking to influence behaviour or increase disclosure.

ESG integration: Responsible Investment as defined by the PRI. The explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and investment decisions based on a systematic process and appropriate research sources.

ESG positive screening: Approach where leading or best-performing investments within a universe, category or class are selected or weighted based on ESG criteria.

Sustainability themed: Investment in themes or assets linked to the development of sustainability. Thematic funds focus on specific or multiple issues related to ESG.

Impact investment: Impact investments are investments made into companies, organisations and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market-to-market rate, depending upon the circumstances.

47. Eurosif (2014), **European SRI Study 2014**

## THE EUROPEAN COMMISSION SHOULD CLARIFY FIDUCIARY DUTY AND PROMOTE RESPONSIBLE INVESTMENT AMONGST ASSET OWNERS

A significant barrier to growth of responsible investing is the fact that some financial institutions still consider the integration of ESG factors in their investment decisions to be in contradiction with their fiduciary duties (Box 2). This was confirmed by recent studies by EY and the United Nations Environment Programme Finance Initiative (UNEP-FI)<sup>48</sup>. However these studies also argue, and provide evidence of, examples where factors are financially material and so taking such factors into account is not a breach of fiduciary duties<sup>49</sup>.

*“The widely recognised need to respond to climate-related risks... means the fiduciary duty debate needs to be resolved finally and quickly.”*

The widely recognised need to respond to climate-related risks and prevent Mark Carney’s ‘Tragedy of the Horizon’<sup>50</sup> means the fiduciary duty debate needs to be resolved finally and quickly. There needs to be a strong signal from regulators<sup>51</sup>. The following is recommended:

> **Recommendation:** The European Commission should end the debate on ESG risk in the context of fiduciary duty as soon as possible<sup>52</sup>. It should provide guidance to the competent Member State authorities on how they should interpret fiduciary duty in the national legal context. This guidance should clarify that asset owners have a duty to pay attention to long term factors including ESG factors where they are likely to be financially material. Authorities should also clarify that assets owners and managers are permitted, and indeed encouraged, to take other ESG issues linked to beneficiaries’ quality of life or ethical views if doing so would not pose a risk of financial detriment to investments.

48. EY (2014) **Resource Efficiency and Fiduciary Duties of Investors**.

UN Global Compact, UNEP-FI and PRI (2016) **Fiduciary Duty in the 21st Century**

49. Freshfields (2005) **A legal framework for the integration of environmental, social and governance issues into institutional investment**

50. Mark Carney (2015) **Breaking the Tragedy of the Horizon – climate change and financial stability** and; Mark Carney (2016) **Resolving the climate paradox**

51. This was resolved in the UK in July 2016. The pension regulator recommended that trustees take into account ESG factors if they deem them to be financially material.

52. This guidance should be provided as a priority during the transposition of the IORPs Directive, where fiduciary duty has been mentioned and amended.

There is widespread support for this approach. Such guidance would be in line with the recommendations of recent research by EY and the PRI; recent guidance from the Securities and Exchange Commission (SEC) in the US<sup>53</sup>; and recommendations from investors such as BlackRock<sup>54</sup>. Providing strategic policy signals such as this is also one of the priority recommendations of the G20 Green Finance Study Group<sup>55</sup>.

## PROMOTING RESPONSIBLE INVESTMENT

In addition to clarification of fiduciary duty, new policies should be considered to actively promote responsible investment. For instance, asset owners should be encouraged to engage with their beneficiaries to understand how they wish their capital to be invested and whether or not they have a preference for it to be invested responsibly. Surveys tend to highlight that savers want their money to be invested more responsibly<sup>56</sup>. Dutch pension fund ABP has put this theory to the test. ABP surveyed its members and found they wanted their money to be invested more sustainably – and this led the fund to significantly increase their responsible investment activities<sup>57</sup>. Increasing the level of engagement that asset owners have with their beneficiaries will have the added benefit of promoting dialogue between financial institutions and retail investors. This will help to improve consumers' trust in financial services - and accountability within the system as a whole. The following is recommended.

> **Recommendation:** The European Commission should improve transparency around responsible investment by proposing mandatory requirements for all asset owners to disclose information about their responsible investment policies and the implementation of those policies. This should result in the asset owners' service providers (asset managers, investment consultants etc.) providing the information and advice their clients need, for example so-called non-financial performance factors, engagement activities (including voting decisions) and their overall impact.

This policy can be linked to the Commission's work on a Pan-European Personal Pensions Product and is in line with responses to the recent Retail Savings consultation<sup>58</sup>. Consulting beneficiaries is unlikely to be a highly costly process for asset owners. Complying with such a requirement could be achieved simply by contacting beneficiaries to ask them their attitudes to their responsible investment policies.

53. UN Global Compact, UNEP-FI and PRI (2016) **Fiduciary Duty in the 21st Century** ; EY (2014) **Resource Efficiency and Fiduciary Duties of Investors** ; US Department of Labor (2015) **Interpretive Bulletin (IB 2015-01) on Economically Targeted Investments (ETIs) and Investment Strategies that Consider Environmental, Social and Governance (ESG) Factors**.

54. BlackRock (2016) **Exploring ESG: A Practitioner's Perspective**

55. G20 Green Finance Study Group (2016) **G20 Green Finance Synthesis Report**

56. NAPF (2014) **What do pension scheme members expect of how their savings are invested**

Ownership Day (2014) **Attitudes to Ownership 2014**

EIRIS (2014) **Half of financial consumers likely to consider switching main provider if they have ethical concerns**

57. This guidance should be provided as a priority during the transposition of the IORPs Directive, where fiduciary duty has been mentioned and amended.

58. The majority of respondents to that **consultation** were in favour of raising consumer awareness about different financial products and improving the transparency and comparability of financial products.

**BOX 2: WHAT ARE FIDUCIARY DUTIES?**<sup>59</sup>

Fiduciary duties exist to ensure that those who manage other people’s money act in the interest of beneficiaries, rather than serve their own interests. The two most important duties are:

- > **Loyalty:** Fiduciaries should act in the interests of beneficiaries, impartially balance the conflicting interests of different beneficiaries, avoid conflicts of interest and not act to benefit themselves or any other third party.
- > **Prudence:** Fiduciaries should act with due care, skill and diligence, investing as an ‘ordinary prudent person’ would do.

In conjunction with requirements that promote dialogue between asset owners and their beneficiaries, it will be important to ensure that asset owners are transparent about their responsible investment policies and how ESG issues are taken into account. Pension fund beneficiaries and retail savers in particular should have the right to know where their money is actually invested, how ownership rights are exercised on their behalf and how responsible investment policies are implemented by those managing their money. There can often be a significant gap between investors’ rhetoric on responsible investment and their actions<sup>60</sup>. Greater transparency will ensure that beneficiaries clearly understand asset owners’ responsible investment strategies, ensuring investors can be held to account and this could help close the gap between rhetoric and action. The following recommendation, which is in line with the G20 Green Finance Synthesis Report<sup>61</sup>, is proposed.

- > **Recommendation:** The European Commission should improve transparency around responsible investment. It should propose mandatory requirements for all asset owners to disclose their responsible investment policy and report on its implementation<sup>62</sup>. These disclosures would, at the least, include specific information about the inclusion of extra-financial performance factors, engagement policy, long-term investment strategies and performance of these policies.

**THE EU SHOULD LEAD ON ALIGNING FINANCIAL FLOWS WITH THE PARIS AGREEMENT**

*“Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.”<sup>63</sup>*

-Article 2, Paris Agreement on climate change

59. UN Global Compact, UNEP-FI and PRI (2016) **Fiduciary Duty in the 21st Century**

60. **PRI plans to delist underperforming signatories**

61. G20 Green Finance Study Group (2016) **G20 Green Finance Synthesis Report**

62. In practice, this could be done through minor amendments to Articles 3f, 3g and 3h of the **Shareholder Rights Directive** which relates to the transparency of institutional investors, asset managers and proxy advisors.

The Paris Agreement requires all public and private financial flows to be consistent with a pathway towards low greenhouse gas emissions and climate-resilient development, and in doing so actively drive the transition to a low carbon economy. To achieve this, the European Commission should ensure that there is a clear understanding of the impact of financial services activities on the climate, including measuring the alignment of financial institutions' activities with EU climate policy objectives.

There is a precedent for such measures in national legislation. France recently implemented Article 173 of its energy transition law which requires investors to disclose their contribution towards meeting climate goals<sup>64</sup>. This regulation should be replicated at EU level, with EU financial institutions required to measure how their activities perform relative to a benchmark that is consistent with global climate objectives. By doing so, financial institutions can understand the impacts their activities have on the environment, which would help them lower the impact and manage their exposures to climate-related risks. At an aggregated level this information would enable regulators and policymakers to develop a better understanding of the financial systems' aggregate impact on climate change and, in turn, could assist with the design of new policies to help manage those impacts. As a result, the following is recommended.

> **Recommendation:** The European Commission should support the development of green finance benchmarks that measure portfolio alignment with climate targets. It should then recommend that Member State prudential regulators adopt regulation that asks financial institutions to disclose whether their activities align with scenarios that keep global temperature increases to below 2°C and also 1.5°C using these benchmarks.

The development of green finance benchmarks is already underway<sup>65</sup>: 2°C investing climate benchmarks are currently available for listed equities and corporate bonds and are being developed for project finance<sup>66</sup>. Policymakers can support their development by improving the quality of corporate reporting, which in turn is closely linked to delivery of the recommendations set out in the next chapter. Taking action in this area would also help the EU meet the G20 Green Finance objective to 'improve the measurement of green finance activities and their impacts'<sup>67</sup>.

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63. UNFCC (2015) **Paris Agreement**

64. 2 Degrees Investing Initiative (2016) **Decree implementing Article 173-VI of the French law for the energy transition: challenges and first recommendations**

65. For example work by the European SEI metrics consortium and the Science-Based Targets Initiative.

66. For a detailed discussion of current progress towards developing green benchmarks see 2 Degrees Investing Initiative (2016) **Measuring progress on greening financial markets: briefing note for policymakers**. Over 100 investors have tested their portfolios against the listed equity benchmark.

67. G20 Green Finance Study Group (2016) **G20 Green Finance Synthesis Report**

# CHAPTER 3

## CLIMATE RISK DISCLOSURES: PROMOTING GOOD GOVERNANCE AND EFFICIENT CAPITAL PRICING

*A whole host of corporate governance failures have and continue to contribute to today's unsustainable business practices, the effects of which include climate change. Shining a light on these practices is an important step to make business practices sustainable. As such, the third objective of the Sustainable Finance Plan should be to ensure companies properly report on their exposures to climate and wider ESG risks. Doing so will give investors the information needed to properly assess and price these risks and allow for effective stewardship of companies.*

*In the case of climate change, investors increasingly recognise that assets worth trillions of euros are exposed to a range of climate risks that must be considered in investment processes. Despite this, current disclosures of information related to such risks are insufficient to enable investors to price financial risks and opportunities correctly. This leads to inefficient capital allocations and slows down the transition to a sustainable and resource-efficient economy. It also brings with it the potential for sudden and very significant market corrections, asset stranding and destruction of value, representing a significant risk to financial stability and shared prosperity.*

A regulatory approach is required to improve the quality of disclosures to the level required for investors and regulators to effectively identify and manage climate risks and broader ESG risks (Box 3). This chapter focuses mostly on climate risk management, which the European Commission should address in two stages. First, existing EU legislation on corporate reporting should be fully enforced and monitored. Second, the European Commission should rapidly develop plans to assimilate the forthcoming recommendations of the Financial Stability Board's (FSB) Taskforce for Climate-related Financial Disclosures (TCFD) to strengthen existing reporting frameworks.

*"Just one-fifth of the world's largest 500 investors are taking tangible action to mitigate their exposure to climate-related risks"*

## CLIMATE CHANGE REPRESENTS A MATERIAL RISK TO COMPANIES AND FINANCIAL INSTITUTIONS

Due to the potentially vast amount of capital at risk from climate change, financial institutions need to be able to identify and manage their exposure effectively. Although many financial institutions are aware of this need, they are in the minority. An Asset Owners Disclosure Project report shows that just one-fifth of the world's largest 500 investors are taking tangible action to mitigate their exposure to climate-related risks<sup>68</sup>. That comes despite the findings of a recent report by BlackRock that "all investors should incorporate climate change awareness into their investment processes"<sup>69</sup>.

*"All investors should incorporate climate change awareness into their investment processes"*

-BlackRock<sup>70</sup>

The current failure to properly identify and price climate-related risks causes inefficient capital allocations in the real economy. By failing to price companies' exposures to climate (and also wider ESG) risks, unsustainable companies continue to enjoy a lower cost of capital than they should. This gives them little incentive to change their operational models. Ensuring that climate-related risks are fully identified will help expose the likely future cost of doing business including, for example, the need to change processes to become more resource-efficient and avoid paying for emissions, and being resilient to future tightening regulation. How well, or not, businesses respond to these dynamics could then be factored into their cost of capital and would send a strong signal that unsustainable business practices must change. In turn this would act to accelerate the process of capital reallocation away from unsustainable and toward sustainable business activities across the economy.

Exposing these likely future costs will help smooth price adjustments as opinions among investors, regulators and governments change, rather than concentrate them in what Bank of England Governor Mark Carney calls a "single climate Minsky moment"<sup>71</sup>. European central banks and financial regulators are increasingly aware of the threat to financial stability of this kind of sudden market adjustment<sup>72, 73</sup>. Whether from transition risks or physical climate risk, the concern is that the scale of impacts would be so big as to pose a systemic risk to the financial system as a whole. As such there is a strong and

68. AODP (2016) **Global Climate 500 Index 2016**

69. BlackRock (2016) **Adapting portfolios to climate change**

70. Ibid

71. Mark Carney (2016) **Resolving the climate paradox**

72. A growing number of public institutions are paying attention to this issue including De Nederlandsche Bank; the Bank of England (2016) **Let's talk about the weather: the impact of climate change on central banks; Finansinspektionen** and the SEC.

73. ESRB (2016) **Too late, too sudden: Transition to a low-carbon economy and systemic risk**

Bank of England (2015) **The impact of climate change on the UK insurance sector**



growing consensus that financial institutions need to fully understand their own exposure, and the exposure of others within the system, to these risks. For this reason, it has been proposed that the European Central Bank should consider a climate stress test of the European financial system<sup>74</sup>.

### BOX 3: ENVIRONMENTAL, SOCIAL AND GOVERNANCE-RELATED RISKS

Mainstream investors increasingly consider ESG risks in their investment decision-making to enhance their traditional financial analysis<sup>75</sup>. Climate-related risks, which are the focus of this chapter, are just one type of ESG risk. The term ESG risk covers a wide-range of different risks that, if unmanaged, can impact the value of investments. Examples include:

- > **Environment:** government policy on climate change, natural resource depletion, pollution, water scarcity and exposure to extreme weather events.
- > **Social:** the observance of human rights, compliance with labour laws, land grabbing, and levels of bribery and corruption.
- > **Governance:** quality of corporate governance, board composition and role in overseeing strategy and corporate pay incentives.

Often environmental, social and governance risks are intertwined and they can be best resolved through improvements to governance aiming to increase the accountability of boards on ESG risk. As such, an EU response to the TCFD should not be thought of as a substitute for broader reforms to the ESG risk reporting landscape.

## CLIMATE RISKS MUST BE REPORTED FULLY AND CONSISTENTLY

Under existing EU legislation (the Accounting Directive<sup>76</sup>), there are already requirements for publicly listed companies to disclose information about the major risks they face in their management reports<sup>77</sup>. Yet despite the growing concern around the materiality of climate change-related risks, they are rarely reported on. As ClientEarth has pointed out, many fossil fuel companies are simply not reporting on the risks that transitioning to a low carbon economy pose to their businesses, even

74. E3G et al. (2016) **Building a Green and Sustainable Capital Markets Union: EU Policy Recommendations**

75. For instance, see: Hermes (2016) **Integrating ESG risks into our investments**;

BlackRock (2016) **Exploring ESG: A Practitioner's Perspective**

76. Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings

77. Under Article 19 of **Directive 2013/34/EU** of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings

if they are existential<sup>78</sup>. As a result, ClientEarth has reported two oil and gas companies to the UK's Financial Reporting Council (FRC) for failing to adequately disclose climate change risks and asking the FRC to take decisive action and oblige these companies to report on climate-related risks to their businesses, as they are required by law to do<sup>79</sup>.

The new European Non-Financial Reporting Directive<sup>80</sup> (NFRD) amends the Accounting Directive to require climate and other ESG-related information to be reported by large publicly listed companies and public interest entities in a non-financial statement (which should ideally feature in their management report). As such it provides a boost to existing requirements under the Accounting Directive. Guidelines on how to provide this information required under the new NFRD are in development. However it is likely that they will focus on the impact of business activity on the environment (including climate change impacts) and society - not the other way around. This is important because of the nature of climate risks and their potential to lead to the permanent destruction of vast amounts of company value. For example, the preamble to the NFRD suggests that companies should report on their use of renewable versus non-renewable energy. But it does not refer to disclosure of information on how a company's infrastructure and supply chains might be affected by the physical impacts of climate change, including increasingly frequent extreme weather events, or how the transition to a low carbon economy might affect the businesses' forward operational model and revenues. As such the information disclosed under the NFRD is likely to be of limited use when trying to understand the financial risks that climate change poses to companies operating in the EU<sup>81</sup>.

These new legal requirements under NFRD build upon a foundation of over 400 different voluntary disclosure regimes developed by industry groups, NGOs, stock exchanges, regulators and international organisations<sup>82</sup>. However, reporting frameworks differ<sup>83</sup> and where disclosures do occur they are often low-quality, relying on boilerplate language and failing to adequately assess exposures to climate and broader ESG risks. One of the most well known and widely used is run by CDP, an NGO that requests and aggregates climate-related disclosures from thousands of European companies

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78. ClientEarth (2016) **Letter to ESMA: climate risk disclosures by companies in the oil and gas, and coal sectors**

79. See: **ClientEarth triggers review of companies' climate disclosures**

80. **Directive 2014/95/EU of the European Parliament and of the Council** of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of so-called non-financial and diversity information by certain large undertakings and groups

81. It is also something of a misnomer to refer to many of these factors, and others such as changes in demand for fossil fuels in a decarbonising world, as 'non-financial' when they pose substantial financial risks to business.

82. Quoted in Mark Carney (2015) **Breaking the Tragedy of the Horizon – climate change and financial stability**. OECD and Climate Disclosure Standards Board (2015) **Report on Climate Change Disclosures in G20 Countries**. Included in this list are advocacy campaigns, platforms for registering sustainability commitments, guidance, policies, ratings schemes, laws, and measurement tools.

83. See OECD & Climate Disclosure Standards Board (2015) **Climate change disclosure in G20 countries: Stocktaking of corporate reporting schemes** and Climate Disclosure Standards Board (2012) **The case for consistency in corporate climate change-related reporting**

on behalf of investors. CDP disclosure requests include detailed information about climate risk and opportunity, governance and forward-looking strategy. CDP collect data using a questionnaire that is updated annually in consultation with institutional investors and collate it in a dedicated online database that can be accessed by investors. CDP's database covers companies whose value is equal to 81% of listed market capital. But while voluntary disclosure regimes such as this can provide useful information, their utility can be limited by concerns over data quality, coverage and consistency.

Inconsistencies in how companies provide disclosures together with the dispersed locations in which they are filed and their variable quality has made it difficult for investors to compare disclosures and to identify what information is material<sup>84</sup>. Incomplete disclosures mean that that information often cannot be scaled up to portfolio-level, while lack of comparability means the information cannot be used to differentiate among firms within the same industry.

There are voluntary efforts underway to try to address these challenges and to provide corporate environmental disclosures in a standardised format - in the same way financial reporting is standardised. Eight NGOs including CDP, the World Business Council for Sustainable Development and the World Resources Institute have come together as the Climate Disclosure Standards Board to create a Reporting Framework for environmental information in their annual reports that is based on financial reporting principles. In 2015 this new framework was used by at least 431 companies to report material and useful information on environmental risk within their annual reports: the emphasis is on consistency, comparability and connectivity to the rest of the annual report. However, in the absence of a mandatory requirement to report in this way, the approach is still in the realm of 'voluntary best practice' and adopted only by the most far-sighted companies<sup>85</sup>.

## STANDARDISATION AND COMPREHENSIVE DATA IS VITAL

In recognition of the fact that insufficient coverage and consistency of disclosures remain one of the biggest barriers to moving forward, the FSB set up the TCFD. The TCFD's mandate is to develop recommendations for voluntary climate-related disclosures that provide decision-useful information to lenders, insurers and investors. The TCFD is undertaking a coordinated assessment of what constitutes efficient and effective disclosures by non-financial and financial companies and will publish its final recommendations in early 2017.

*"When it comes to climate risks, we measure what we can and not what we want"*

-A large institutional investor

84. FSB TCFD (2016) **Phase I Report**

85. Companies are drawn from across sectors and include for example Airbus Group, Coca-Cola HBC AG and Sony Corporation

This work is necessary because, in the words of one large institutional investor, ‘when it comes to climate risks, we measure what we can and not what we want’<sup>86</sup>. This inability for investors to assess climate-related risks of investments is, as noted above, caused by inadequate regulatory oversight and the fact no enforcement action is taken against companies who fail to properly report their exposures to these risks. As a result, investors do not have the full range of information they need to properly measure or manage their own exposure to these risks.

The lack of usable information has led many investors to table shareholder resolutions at the AGMs of companies currently most at risk: fossil-fuel and mining companies. Investors have asked for more detailed information about the companies’ exposure to climate-related risks. Examples of such initiatives include the shareholder resolutions successfully passed at BP and Shell in 2015.

Shareholder resolutions are an effective technique for raising the profile of issues within companies but are also a costly and time-consuming one<sup>87</sup>. ShareAction’s analysis of the companies’ disclosures as a result of such resolutions highlights concerns about the level of these companies’ engagement with the impact of the transition to a low-carbon economy on their business models<sup>88</sup>. As such it argues for an enhanced approach to disclosures.

## MOVING FORWARD: BUILDING A WORLD-CLASS DISCLOSURES REGIME

Improving the disclosures of climate-related information by companies and investors so that they become ‘decision-useful’ should be done in two stages: (1) improving regulatory scrutiny and enforcement and (2) improving information.

First, regulatory scrutiny and enforcement of corporate risk disclosures should be improved. The European Commission should work with the European Securities and Markets Authority<sup>89</sup> (ESMA) and national financial regulators to determine how this can best be achieved. This could include regulators explicitly including the management of climate risk within their existing mandates. This more explicit oversight role could be complemented with revisions to the existing legal framework on disclosures to ensure the appropriate information to enable them to carry out this role available.

Second, the European Commission should ensure decision-useful information is available to investors and regulators. To do this, it should work to assimilate the recommendations of the TCFD into existing reporting frameworks. These recommendations, a draft of which is expected in December 2016, are

86. See Business and Climate Summit 2016 ‘Risk Disclosure’ session

87. For example, the ‘Aiming for A’ investor coalition has tabled shareholder resolutions at BP, Shell, Anglo American, Glencore and Rio Tinto in the past year.

88. <https://shareaction.org/wp-content/uploads/2016/05/Analysis-ShellClimateReporting2016.pdf>  
<https://shareaction.org/wp-content/uploads/2016/04/Ananalysis-BPClimateReporting2016.pdf>

89. ESMA has a mandate to help safeguard the EU’s financial system by enhancing the protection of investors and promoting stable and orderly financial markets

expected to include guidelines on how companies can provide information about their: governance; strategy and risk management processes in relation to climate-related risks; and disclosures of specific, climate-related metrics and targets.

The European Commission should use the opportunity created by the TCFD to build a world class climate disclosure regime in the EU. It should go beyond the proposed voluntary approach and instead seek means to ensure the TCFD's recommendations are assimilated into the existing mandatory framework. Mandatory disclosures will allow investors to fully understand and report on the climate risk exposure across their portfolios. Exposing future costs will also help smooth price adjustments and enable investors to engage companies on the need to manage climate risks to protect the value of their investment. In this way companies, investors and regulators will have the information needed to work to avoid the "single climate Minsky moment" that puts European financial and economic stability at risk.

The TCFD is set to finalise its recommendations in early 2017 with a period of public consultation between December 2016 and final publication. Ahead of this the following recommendation is made.

**> Recommendation:** The European Commission should incorporate into the mandate of the new expert group on sustainable finance an early focus on how recommendations from the TCFD can be best assimilated into the EU's existing reporting framework. It should also consider two other issues: through what means decision-useful reporting can be best enforced to enable regulators at a national and EU level to fully understand the financial systems' exposure to climate risk; and the need to move beyond reporting of risk to how companies intend to take action and report on efforts to mitigate those risks.

# CHAPTER 4

## CONCLUSION AND NEXT STEPS

*There is a strong political case for the Commission to move beyond mechanistic reforms to the functioning of Europe's capital markets to look more at how they can be repurposed to explicitly address Europe's social and environmental challenges. A renewed focus on delivering more sustainable development and inclusive prosperity through placing these issues at the heart of financial reforms would help to restore confidence in both the European project and in the financial system to deliver a climate-resilient, greener, safer and more equitable society.*

With several Member States moving forward – on the basis of long-term growth and competitiveness concerns – with their own green and sustainable finance initiatives, some coordination at EU level looks increasingly necessary. Failure to do so risks fragmented regional capital markets regulation, which will undermine the aim of building a single market for capital in the EU. This gives the Commission a strong mandate to act and will put the EU on the front foot to respond both to the Hangzhou G20 Communiqué, which included a focus on Green Finance, and to the FSB Taskforce on Climate-related Financial Disclosures.

The European Commission's stated commitment to setting up expert group to develop a comprehensive strategy on sustainable finance is very welcome. It will be important that this initiative has clear aims and objectives, and works towards delivering a concrete Plan for Sustainable Finance. The following three overarching objectives are suggested.

- > **Sustainable infrastructure:** Deliver the levels of investment in sustainable infrastructure required to meet EU climate and energy targets and avoid investments in infrastructure and other projects which could undermine these targets. Doing so would deliver environmentally and economically sustainable growth.
- > **Responsible investment:** Ensure that the private financial sector supports sustainable, inclusive development across the EU including delivery of the UN SDGs and the Paris Agreement on climate change. This would act to reverse growing levels of inequality in the EU<sup>90</sup>.

90. Globally, inequality is increasingly being recognised as a major threat to social stability. In Europe, inequality has grown markedly since the mid-1980s, with 122 million people now deemed to be at risk of social exclusion

- > **Climate risk disclosure:** Ensure that companies and financial institutions properly understand and report on their exposure to climate-related risks. This would encourage a longer term approach to business planning and enable investors to become stronger agents, and indeed stewards, of change.

This Sustainable Finance Plan includes the following recommendations for achieving these aims and objectives.

## Sustainable infrastructure

- > **Recommendation 1:** The Sustainable Finance Plan 2030 should explicitly link the Capital Markets Union and Investment Plan to the Energy Union, by asking for Member States to develop National Capital Raising Plans as part of their National Energy and Climate Plans. This would make sustainable investment opportunities more visible to the private sector and increase investor confidence in the National Energy and Climate Plans.
- > **Recommendation 2:** To effectively crowd in private capital, the Sustainable Finance Plan 2030 should ensure that all European financial public sector risk sharing tools (e.g. EFSI and Project Bonds Initiative but also grants and financial instruments developed under the wider Multiannual-Financial Framework) are fully aligned with the EU's climate targets and sufficiently scaled to close the investment gap.
- > **Recommendation 3:** The European Commission should support the rapid development of robust, fully developed and widely accepted industry standards for green bonds. Following that it should use its convening power to stimulate debate with Member State governments on the role of fiscal policy in promoting the green bond market – linking it back to the development of National Capital Raising Plans.

## Responsible investment

- > **Recommendation 4:** The European Commission should end the debate on ESG risk in the context of fiduciary duty as soon as possible. It should provide guidance to the competent Member State authorities on how they should interpret fiduciary duty in the national legal context. This guidance should clarify that asset owners have a duty to pay attention to long term factors including ESG factors where they are likely to be financially material. Authorities should also clarify that assets owners and managers are permitted, and indeed encouraged, to take other ESG issues linked to beneficiaries' quality of life or ethical views if doing so would not pose a risk of financial detriment to investments.
- > **Recommendation 5:** The European Commission should develop legislative proposals to require asset owners to consult their beneficiaries on their attitude to and preference (or not) for having their money invested sustainably. Such a proposal would improve accountability in the investment system and build trust in financial services as a force for good.

- > **Recommendation 6:** The European Commission should improve transparency around responsible investment by proposing mandatory requirements for all asset owners to disclose information about their responsible investment policies and the implementation of those policies. This should result in the asset owners' service providers (asset managers, investment consultants etc.) providing the information and advice their clients need, for example so-called non-financial performance factors, engagement activities (including voting decisions) and their overall impact.
- > **Recommendation 7:** The European Commission should support the development of green finance benchmarks that measure portfolio alignment with climate targets. It should then recommend that Member State prudential regulators adopt regulation that asks financial institutions to disclose whether their activities align with scenarios that keep global temperature increases to below 2°C and also 1.5°C using these benchmarks.

## Climate risk disclosure

- > **Recommendation 8:** The European Commission should incorporate into the mandate of the new expert group on sustainable finance an early focus on how recommendations from the TCFD can be best assimilated into the EU's existing reporting framework. It should also consider two other issues: through what means decision-useful reporting can be best enforced to enable regulators at a national and EU level to fully understand the financial systems' exposure to climate risk; and the need to move beyond reporting of risk to how companies intend to take action and report on efforts to mitigate those risks.

As the G20 Green Finance Synthesis Report notes there are many actions that could and should be undertaken to 'green' the finance system. The recommendations presented here are drawn from a sister discussion document "Building a Green and Sustainable Capital Markets Union: EU Policy Recommendations<sup>91</sup>" and have been prioritized on the basis of feasibility, urgency and impact.

The time is right for the European Commission to develop and deliver a bold vision for how it will deliver more sustainable finance in the EU. There is strong and growing support among investors and Member States governments for the European Commission to move further and faster on this agenda. We look forward to seeing the European Commission bring forward the proposals for new market rules, oversight and incentives to enable market participants to focus on long-term value creation while boosting sustainable infrastructure investment, tackling climate change and delivering inclusive prosperity in Europe.

91. E3G et al. (2016) **Building a Green and Sustainable Capital Markets Union: EU Policy Recommendations**



