



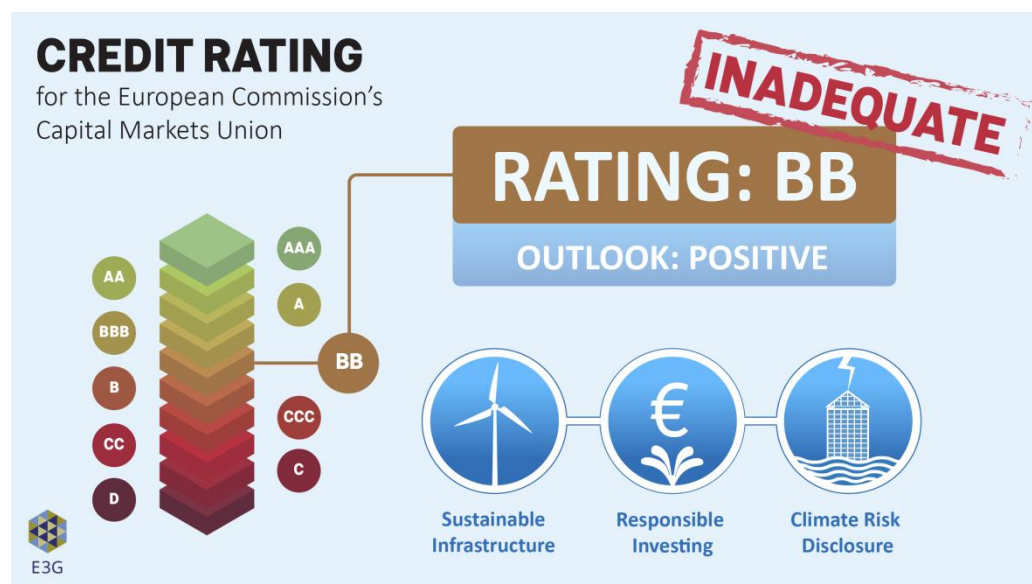
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**BRIEFING PAPER** OCTOBER 2016

## THE STATE OF THE CAPITAL MARKETS UNION HAS IT DELIVERED ON SUSTAINABILITY?

**SAM MAULE AND INGRID HOLMES**

The Capital Markets Union (CMU) was set up to provide new sources of funding for business, help increase options for savers and make the economy more resilient. To deliver this overarching ambition, the CMU has five sub-objectives. One of these is to ensure “an appropriate regulatory environment for long term, sustainable investment and financing of Europe’s infrastructure”<sup>1</sup>.



This briefing paper assesses the progress made in delivering sustainable investment, by scoring progress made against what E3G regards as the core principles necessary to achieve this. They are: delivering sustainable infrastructure; supporting sustainable

<sup>1</sup> European Commission (2015) **Action Plan on Building a Capital Markets Union**



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development; and improving understanding of climate and other ESG-related risks. The CMU is given a 'credit rating' based on the actions taken so far and those it planned under the next phase of initiative.

Overall, one year on from the publication of the CMU Action Plan, the CMU is given a 'BB' rating for sustainability. To date the focus on delivery of the sustainability objectives has been inadequate. Additional policies are required to boost investment in sustainable infrastructure, help deliver the UN's Sustainable Development goals and understand climate and ESG risks. Currently there is a €100bn a year energy infrastructure investment gap. This risks Europe's ability to meet its obligations under the Paris Agreement to deliver its 2030 climate and energy targets and to make "finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development".

This review should be a useful sense-check as the European Commission moves forward with its refresh of the CMU. While the rating is currently BB, we regard the outlook as positive. On 14<sup>th</sup> September 2016 the European Commission announced that it will establish an expert group with responsibility for developing a comprehensive European strategy on sustainable finance<sup>2</sup>. The expert group represents a significant new commitment by the European Commission both to pursue the 'greening' of the EU financial system and to build a supportive regulatory environment in which to deliver sustainable development. We suggest setting out to address the policy gaps outlined in this briefing paper should be a core focus for this group<sup>3</sup>.

The remainder of the paper is structured as follows. The first section sets out the three principles against which the CMU is assessed. These have been developed in conjunction with a wide range of NGOs, think tanks, academics and investors working on sustainable finance<sup>4</sup>. The following sections look at each of the principles in turn and assess the CMU against them.

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<sup>2</sup> E3G (2016) [Europe pledges sustainable finance boost](#)

<sup>3</sup> E3G and a range of partner organizations will publish a 'Sustainable Finance Plan for the European Union' in October 2016 which will take a closer look at policies the European Commission could implement in conjunction with the sustainable finance working group.

<sup>4</sup> E3G would like to acknowledge the following organisations for their contribution: 2 Degrees Investing Initiative, Action Aid, Ario Advisory, Aviva, Cambridge Institute for Sustainability Leadership, Carbon Tracker Initiative, CDP, Climate Disclosure Standards Board, ClientEarth, Climate Bonds Initiative, Climate Disclosure Standards Board, Eurosif, FERN, Finance Watch, Frank Bold, Friends of the Earth Europe, Global Witness, Hermes, Institutional Investor Group on Climate Change, Impax, Mirova, Preventable Surprises, Rainforest Action Network, Schroders, ShareAction, SOMO, Smith School Stranded Assets Programme, Tomorrow's Company, UNEP-FI, WHEB and WWF.



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## Principles for a Sustainable Capital Markets Union



### **Investment in sustainable infrastructure should be sufficient to ensure future prosperity**

Infrastructure is the backbone of the economy. Well-designed infrastructure projects have significant economic benefits: they provide jobs, boost productivity and are essential for sustainable development. Yet much of Europe's existing infrastructure is coming to the end of its productive life and current investment levels are too low to see it replaced with the sustainable infrastructure need to deliver a low carbon and climate resilient economy<sup>5</sup>. To do this, private sector capital will be required. As such, the new strategy for sustainable finance should include reforms that help close current shortfalls in investment – estimated to be €100bn per year in the energy sector alone and €435bn per year across all infrastructure<sup>6</sup>.



### **The financial system should support sustainable and inclusive development**

The global economy faces substantial threats from environmental and social factors including climate change, water scarcity and inequality. All financial institutions, and especially those that invest for the long-term, should be required to explicitly consider financially material environmental, social and governance (ESG) factors in their investment decisions. Doing so will start to correct the market failures caused by short-termism and contribute to more efficient capital allocations. Going further, policies should be implemented that encourage the mainstreaming of responsible investment practices. In doing so, these measures can help the EU meet its obligations under both the Paris Agreement and the UN Sustainable Development Goals.



### **Financial market participants should understand climate-related risks**

The financial sector increasingly recognises the risks and opportunities inherent in a changing climate. Nevertheless, the quality of disclosures of climate-related information is poor and inconsistent<sup>7</sup>. This lack of information risks the mispricing and inefficient allocation of capital in relation to climate risk. The resulting potential for large and abrupt corrections in asset values could threaten financial stability<sup>8</sup>. Improving corporate and financial institution understanding of these risks – as the FSB's Taskforce for Climate-related Financial Disclosures aims to do – is one step toward ensuring these risks are considered. Better disclosures will also improve the quality of information investors have as they consider ESG factors, which could help accelerate the mainstreaming of responsible investment strategies.

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<sup>5</sup> European Investment Bank (2016) **Restoring EU competitiveness**

<sup>6</sup> European Investment Bank (2016) **Restoring EU competitiveness**

<sup>7</sup> Disclosures made in statutory filings are mostly poor or non-existent, while separate disclosures (for example through voluntary initiatives such as CDP, or in corporate sustainability reports) may contain more information but still may not help investors to understand what is material.

<sup>8</sup> Task Force on Climate-related Financial Disclosures (2016) **Phase I Report of the Task Force on Climate-Related Financial Disclosures**



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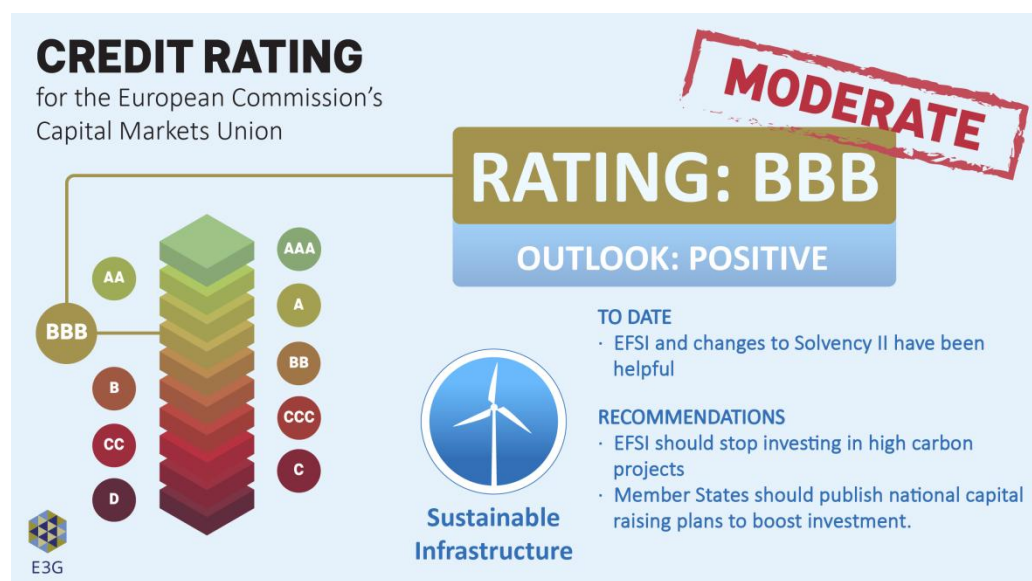


## Investment in sustainable infrastructure should be sufficient to ensure future prosperity

### Actions so far:

In April 2016 the amount of capital insurance companies have to hold against their investments in infrastructure and European Long Term Investment Funds was reduced when Solvency II calibrations were adjusted<sup>9</sup>. These adjustments make investments in infrastructure projects more attractive to insurers.

Outside of the CMU, but nevertheless relevant for this objective, the European Fund for Strategic Investment (EFSI) aims to mobilise at least €315bn in additional investment over 2016-18 to support investments in strategic areas like infrastructure, education, R&D and SMEs. So far, €127bn has been mobilised<sup>10</sup>. In September 2016, it was announced that EFSI will be expanded to at least €500bn and lengthened to 2020 and at least 40% of the funds will be used for climate action, up from around one-third today<sup>11</sup>.



<sup>9</sup> European Commission (2016) **Capital Markets Union: First Status Report**

<sup>10</sup> EIB (2016) **EFSI Dashboard**

<sup>11</sup> European Commission (2016) **State of the Union 2016: Strengthening European Investments for jobs and growth**



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### Future plans:

The European Commission will consider the extent to which regulation of banks (specifically the Capital Requirements Regulation) is affecting bank lending to infrastructure projects and other long term investments<sup>12</sup>. It will assess whether the evidence of the 2015 public consultation on this topic warrants an adjustment of capital requirements. This measure has the potential to increase bank lending to low-carbon, climate resilient infrastructure projects which could help to close current investment gaps.

The Commission is also in the process of putting together a study that looks at the potential of the green bond market to finance resource-efficient investments. This study is set to be published towards the end of 2016.

### Assessment:

A range of different actions have been taken to try to boost investment in sustainable infrastructure in the EU, but these are unlikely to be sufficient as they stand so a 'BBB' rating is awarded. The changes to Solvency II regulation and potential changes to CRR go in the right direction but it's too early to tell how impactful they will be in terms of boosting investment in infrastructure. In addition, investments in low-carbon, climate resilient infrastructure are currently treated no differently to high-carbon infrastructure.

The EFSI has helped to mobilise capital to build more sustainable infrastructure in the EU. Nevertheless, investments in high carbon projects continue and some key priorities like energy efficiency have received little<sup>13</sup>. E3G analysis suggests that 18% of EFSI funds have been invested in high-carbon projects<sup>14</sup>. In addition, some groups have criticised the EFSI for being too risk averse and not delivering truly 'additional' investments. This risks private investors being crowded out rather than in<sup>15</sup>. Given the huge investment gap, the European Commission could go further. The recent announcement of the expansion of EFSI and increased focus on climate action is welcomed and contributed to the rating being put on 'positive outlook'. In the next stages of EFSI, there should be no further investment in high-carbon projects.

The Commission's work on green bonds has the potential to improve investor confidence in this asset class and ensure continued growth of the market. But more now needs to be done. First, the European Commission should support the rapid development of robust, fully-developed and widely-accepted industry standards for

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<sup>12</sup> European Commission (2016) [Capital Markets Union: First Status Report](#)

<sup>13</sup> E3G (2016) [Europe needs a stronger investment plan for the Energy Union](#)

<sup>14</sup> E3G (2016) [A Mission-Oriented Budget: Priorities for the MFF Mid-Term Review](#)

<sup>15</sup> Bruegel (2016) [Assessing the Juncker Plan after one year](#)



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green bonds. The European Commission should work to facilitate a situation that ensures issuing a green bond is, at the least, no more costly than issuing a regular bond. To do 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.

One key barrier to further investment in infrastructure that has not been sufficiently addressed is the fact that there are not enough sustainable infrastructure assets to invest in. Improving the pipeline of infrastructure projects – for example by requiring the inclusion of national capital raising plans within Member States' 2030 National Energy and Climate Plans<sup>16</sup> – should be a core focus of future Commission work.

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<sup>16</sup> E3G et al. (2016) A Sustainable Finance Plan for the EU (forthcoming)



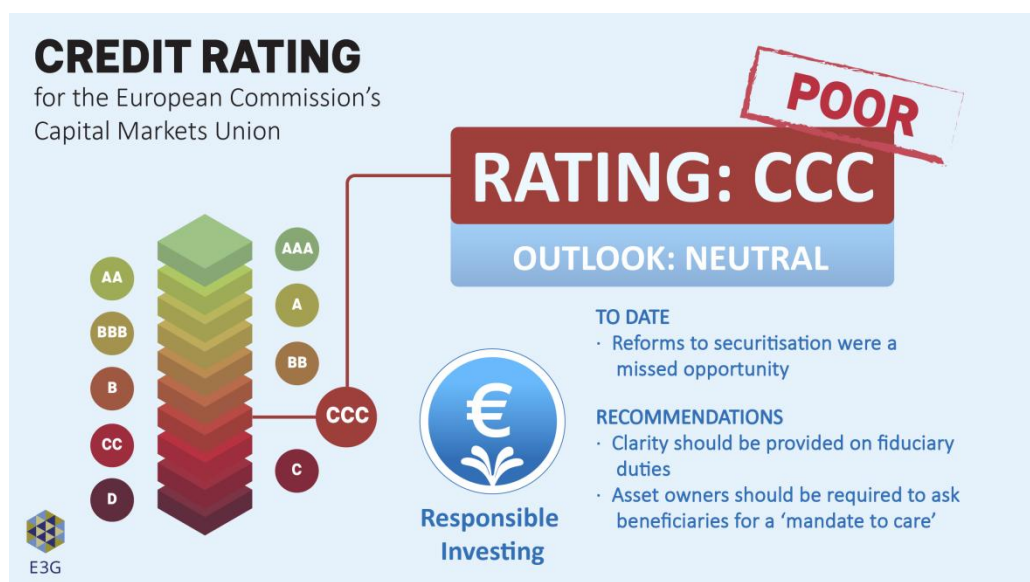
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## The financial system should support sustainable and inclusive development

### Actions so far:

To date no policies have been proposed within the CMU focused on shifting the EU finance system to support sustainable and inclusive development. The reforms to the European securitisation market were a missed opportunity to ensure climate and wider ESG risk was assessed and identified by issuers as an integrated part of the securitisation process. Amendments to that effect have since been added by the European Parliaments' ECON Committee. Because of this missed opportunity, the CMU is given a 'CCC' rating instead of the neutral 'B' rating.



### Future plans:

The Commission has begun a process under the CMU that could lead to the development of policies to promote sustainable and inclusive development. In December 2015, a public consultation was undertaken to understand on how institutions in the investment chain factor in environmental, social and governance (ESG) information into their investment decisions. The consultation closed in March 2016 but the Commission have not yet published the results nor outlined how the results will be used.





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The Commission has also outlined that the CMU will be essential for the implementation of the Paris Agreement on climate change but, again, hasn't provided any specific policies that could help it implement the Paris Agreement<sup>17</sup>.

**Assessment:**

It is positive that the Commission is seeking to better understand how ESG information is used by the financial sector. However, the rating is given a neutral outlook since the European Commission has yet to share the findings of its consultation and has not published any new policy proposals to expand the use and integration of ESG information in day-to-day investment practices.

To achieve a ratings upgrade, new policies should be considered. For example, the European Commission should send a clear message that fiduciary duties are not a barrier to integrating ESG information into their investment decisions – this would end a debate that unnecessarily continues in some parts. Doing so would be in line with the recommendations of a recent report completed for the European Commission by EY in 2015<sup>18</sup>. In addition greater accountability of assets owners and managers to their beneficiaries should be encouraged – for example by requiring institutional investors to consult formally with beneficiaries to understand their preferences regarding sustainable investment.

In addition as part of its work on sustainable finance the European Commission should publish a plan on how to align financial policy with the EU's climate goals and the Paris Agreement. Subsequently, a plan should be developed to align with the UN's Sustainable Development Goals. One first step the Commission could take on alignment with the Paris Agreement is to ask financial institutions to measure whether their activities are consistent with the objective to keep global temperature increases to 1.5-2°C – as Article 2 of the Agreement requires<sup>19</sup>.

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<sup>17</sup> European Commission (2016) **The Road from Paris**

<sup>18</sup> EY for European Commission (2014) **Resource Efficiency and Fiduciary Duties of Investors**

<sup>19</sup> UNFCCC (2015) **Paris Agreement**





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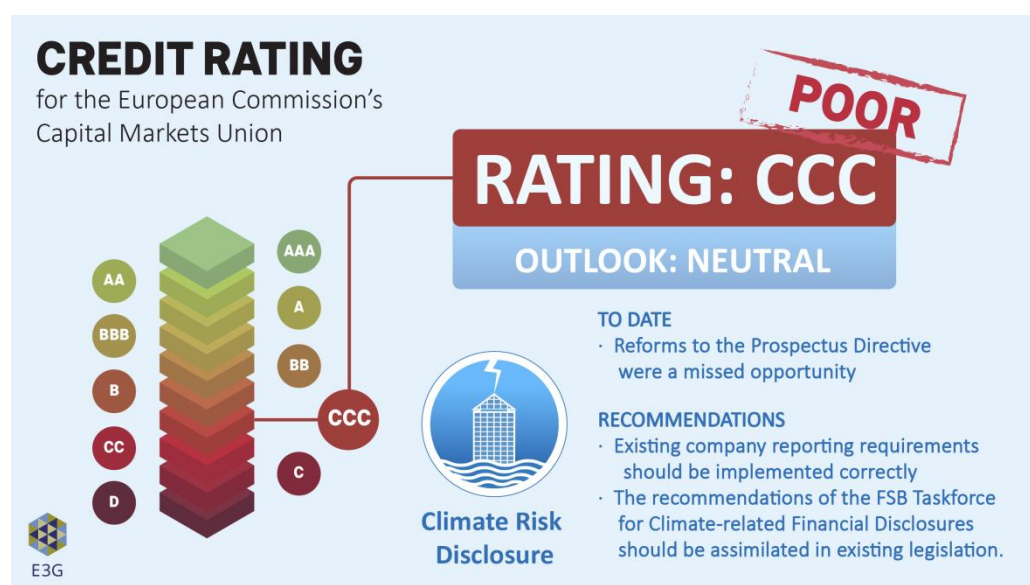


## Financial market participants should understand climate-related risks

### Actions taken so far:

So far no policies have been proposed under the CMU to ensure climate-related risks are fully disclosed and understood.

The Commission has proposed changes to the Prospectus Directive – the regulation that determines the contents of financial prospectuses when companies attempt to raise money on capital markets – primarily to make it easier for smaller companies to access capital market finance. The Commission should have used this opportunity to reaffirm that companies need to disclose financially material ESG factors – to mirror recent changes to pension fund (IORPs) regulation<sup>20</sup>. The Council has outlined the need for disclosures of this kind in their unofficial position on the Prospectus Directive. In light of this missed opportunity, a CCC rating is given instead of a neutral 'B'.



### Future plans:

In April 2016 the Commission completed a public consultation on how it should design guidelines to help companies disclose social and environmental information in accordance with the Non-Financial Reporting Directive. This was followed by a stakeholder workshop held in September 2016. This Directive determines how

<sup>20</sup> ShareAction (2016) IORPs



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companies should disclosure information related to non-financial and diversity information<sup>21</sup>.

**Assessment:**

The consultation on the Non-Financial Reporting Guidelines is useful, but only to a limited extent. Non-financial reports can provide information to investors on the impact of a company’s activities on the environment – for example their use of renewable energy versus non-renewable. This can then help investors engage with companies on climate and wider ESG risks as well as work to align their portfolios in accordance with the better management of climate change risks or wider ESG considerations. However, the guidelines (as currently structured) are unlikely to be useful for companies that are trying to provide a Non-Financial Report tailored to the needs of investors. Crucial issues such as comparability, materiality or even a clear definition of the target audience of Non-Financial Information (which must be investors since the Directive addresses capital-market oriented companies) are not clearly defined.

In addition, the Commission has not provided any information around how it plans to respond to the Financial Stability Board’s (FSB) Taskforce for Climate-related Financial Disclosures, which was established to provide voluntary standards for companies’ disclosure of climate-related information. Nor has the Commission provided assurances that it will ensure current regulations that require the disclosure of material risks, including those related to climate change, are fully implemented in Member States. Undertaking both of these actions will be vital in order to achieve a ratings upgrade against this principle.

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<sup>21</sup> European Commission (2016) **Capital Markets Union: First Status Report**



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## Annex: Credit rating methodology

The three principles that the Commission's CMU actions are being rated against have been designed by E3G and incorporate the views of a wide range of institutions about the aspects of sustainability that are most relevant for capital markets. We have drawn on a wide range of work including that of the UNFCCC and the Paris Agreement on climate change, the UN Sustainable Development Goals, UNEP-FI and the FSB's Taskforce for Climate-related Financial Disclosures.

The overall 'credit rating' reflects our assessment of how the actions and communications from the European Commission line up with the three principles for a sustainable CMU. The ratings for each of the three principles have been combined into an overall rating. The rating consists of two parts: the letter dimension (e.g. AAA), which reflects how actions already taken by the Commission line up with our principles, and the outlook (positive/neutral/negative), which reflects our assessment of the likely direction of travel, based on communication from the European Commission.

As with a conventional credit rating, the scale runs from AAA (the highest rating) to D (the lowest). The table below defines each rating.

Rating		Description
AAA	Excellent	The Commission has or will implement policies that are fully consistent with the principles and are likely to be sufficient.
AA	Very good	A 'AA' rating differs only slightly from the 'AAA' rating – either the principles is not fully met or may not be sufficient.
A	Good	The Commission has or will implement policies that largely comply with the principles and may not be sufficient.
BBB	Moderate	The Commission has or will implement policies that somewhat comply with the principles but are unlikely to be sufficient.
BB	Inadequate	The Commission has or will implement policies that somewhat comply with the principles but are highly unlikely to be sufficient.
B	Neutral	The Commission has not implemented and isn't in the process of implementing, any policies related to the principles. Or, the Commission has, or will, implement a range of policies that are likely to have a neutral or negligible overall impact.
CCC	Slightly	The Commission has implemented, or is in the process of implementing, policies that, on balance, run somewhat against the



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	poor	principles but are likely to have a small impact.
CC	Moderately poor	The Commission has or will implement policies that run somewhat against the principles and may have a significant impact.
C	Very poor	The Commission has or will implement policies that run against the principles and may have a significant impact
D	Extremely poor	The Commission has or will implement policies that run against the principles and are will have a significant harm.

### About E3G

E3G is an independent, non-profit European organisation operating in the public interest to accelerate the global transition to sustainable development. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere.

More information is available at [www.e3g.org](http://www.e3g.org)

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