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INTRODUCTION

The European financial framework should be reformed in order to align EU financial policies and legislation with environmental, social and governance factors (ESG), notably from international commitments like the Paris Agreement and the Sustainable Development Goals (SDGs). The European financial system still has many barriers to overcome but also offers opportunities.

The European Commission has taken first steps towards a more sustainable financial system, including integrating sustainability considerations into the IORPs II Directive, the Shareholder Rights Directive, the STS regulation, the Non-Financial Reporting Guidelines and the ‘ESAs package’ and prioritising sustainability in the Capital Markets Union Midterm Review Action Plan.

At Member State level, the UK has launched a plan to accelerate the growth of green finance. Sweden has created a ‘Swedish toolbox’ for a sustainable financial system with some initiatives like, for example, the Swedish FSA’s ambitious agenda to integrate sustainability into its daily work. France, one of the leading Member States on sustainable finance, has implemented mandatory ESG disclosure (Article 173) as part of its Energy Transition Law, and its new ‘Acceleration’ initiative urges the transition to a sustainable financial system. The increasing amount of national initiatives signals political support to standardise and mainstream ESG also on the European level.

The High-Level Expert Group on Sustainable Finance (HLEG) published its final report the 31st January 2018, focusing on key eight recommendations, including an EU sustainability taxonomy; clarification of investors’ duties; upgrading disclosure rules; etc. The ongoing national and international initiatives in sustainable finance bring an unprecedented momentum at the same time as the HLEG is calling for capital to mobilise on two imperatives: financial stability and inclusive growth (1). This comes at a time when the need to make finance sustainable begins to be recognised as the only way forward, political support is rising, and investors increasingly become aware of their responsibilities and role to ensure finance serves society. Good practices and ESG principles will visibly contribute to European economic prosperity and a prospering sector.
At the global level, frameworks such as the Paris Agreement on climate and the Agenda 2030 including the Sustainable Development Goals (SDGs) set universal minimum standards for sustainability. The G20 discussions and the FSB Task Force on Climate-related Financial Disclosure (TCFD) provide further advances on the mandatory disclosure by financial institution of their exposure to the risk of climate change, and their mitigation strategies. While in addition the Global Deal (2) addresses inclusive growth and sets standards for social dialogue in a globalization process that benefits all.

All these initiatives create an unprecedented momentum on sustainable finance that should be harnessed by the European Commission in order to deliver bold and ambitious financial regulatory reform producing systemic change.

On the basis of the HLEG final recommendations, the Commission committed to develop an EU Sustainable Finance Action Plan that we understand will be published in March 2018. We welcome the European Commission's initiative to create an overarching sustainable finance strategy and hereby propose concrete recommendations that we consider of utmost importance for such an Action Plan.

We NGOs have been individually, and in some cases collectively, working to reform Europe’s financial sector for a number of years. Together we represent twelve member organizations. Based on this long-term engagement we have put together this anthology of analysis, positions and recommendations for what we consider to be the priorities for an EU Sustainable Finance Action Plan.
ESG TAXONOMY, STANDARDS AND LABELS

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The need for a robust and mandatory mechanism for assessing, mitigating and disclosing environmental, social and governance factors and risks in the finance sector

OUR ANALYSIS .01

The voluntary and self-regulatory nature of Europe’s mechanisms for assessing and mitigating the environmental, social and governance (ESG) factors and risks of financial investors is resulting in inconsistent application, causing social and environmental harm, and exposing the sector to financially material costs. An overarching taxonomy (i.e. definition) of ESG factors and risks, implemented through a mandatory methodology of due diligence, disclosure and accountability is urgently needed.

European investors, particularly those from the UK, Germany, Netherlands and France, are involved in many large-scale overseas agribusiness projects (3). For example, EU financial institutions are major holders of shares in stock-market listed agricultural companies based in developing countries; in early 2015 the top 20 EU institutional investors held US$2.8 billion (4). European investors are financially involved in projects causing land grabbing, human rights abuses and deforestation overseas (5).

These investments don’t just carry ethical concerns; they also risk financially material impacts for corporations and investors (6). The average operating costs of a three-year US$10 million project could increase by 29 times if disrupted by local opposition (7) and companies which fail to address disputes with local communities are increasingly losing their licenses (8). Consequently some are proactively divesting; the Norwegian Government Pension Fund Global has withdrawn investments from a significant number of palm oil and logging companies over hu-
Corporations and investors involved in such projects are also losing out on the investment opportunities of operating responsibly; numerous studies have shown that integrating ESG factors and risks into the investment process has an overall positive impact on corporate financial performance. (10)

Europe’s financial sector can no longer ignore ESG factors or risks – neither the harm caused nor the opportunities missed – however progress is restricted by two major regulatory challenges. Firstly, EU investors are currently expected to define their own risks, on a voluntary basis, leading to inconsistent application and disclosure, and inhibited external monitoring (11). Secondly, even for those regulations which do specify ESG factor or risk management, adherence is non-binding, based on a “comply or explain” model (12). Consequently, there are very limited means through which such investors can be held to account; either by those harmed by these projects on the ground, or by those whose finances are being put at risk.

The flaws of reliance on non-binding measures are well-documented; (13) the UNEP’s Inquiry into the Design of a Sustainable Financial System concluded that sustainability reporting had not yet proven to have had any improvements in social or environmental performance on the ground. (14)

OUR RECOMMENDATIONS .02

A. Binding mechanism for assessing and mitigating ESG factors and risks

The sustainable transformation of Europe’s financial sector is contingent on guaranteeing the full integration of ESG management systems into on-going decision-making along all investment and lending chains. Given the failure of existing market-based measures to achieve this, regulatory routes must be introduced. We recommend that such regulations involve a standardised taxonomy of ESG factors and risks adopted by all investors and firms across Europe, which is then implemented through a binding, statutory-based methodology.

1. An ESG factor and risk taxonomy

The ESG factor and risk taxonomy should build on sustainable development as defined in the Agenda 2030 (15), the Sustainable Development Goals, incorporate commitments from the Paris Agreement and be in line with international human rights, labour and environmental laws and policies:

- Environmental risks – broad-based negative environmental impacts, including climate change risks, resource depletion, waste, pollution and deforestation;
- Social risks – all existing human rights obligations, customary rights, worker’s rights, women’s rights,
health and safety, and conflict situations;

- Governance risks – including internal corporate governance, tax strategies, board strategy and diversity, and measures to tackle corruption and money laundering.

As such, we support the UNEP Inquiry definition (16) proposed for 'sustainability factors' (particularly its inclusion of broader environmental issues and human rights) as more appropriate than the PRI definition, referred to in some EU regulation (eg IORP II).

The EU, particularly financial supervisory authorities, should then develop a methodology for systematically embedding this ESG risk taxonomy within binding financial regulations, for example the AIFMD, SRD II and IORP II. Such regulations would need to comprise of robust due diligence, improved disclosure and effective accountability.

2. A mandatory methodology of due diligence, disclosure and accountability

a) Due diligence requirements across the full range of intermediaries in the investor and lending chain, which assess their ESG factors and risks, as follows:

- Requires investors to consider their on-going financially material ESG risks as well as actual or potential social and environmental impacts (e.g. building upon the Non-Financial Reporting Directive, Articles 19, 19(a), Recitals 3, 6, 6(a) and 6(b));
- Requires investors to develop a time-bound engagement policy with those they invest in (e.g. based on Shareholder Rights Directive Article 3(g)(a)) which requires firms (etc.) to assess ESG risks and take adequate steps to avoid or mitigate them;
- Including obliging issuers and intermediaries promoting investments in land-based projects to include in prospectuses proof of “good title”, ensuring that the land has not or will not be grabbed.

b) Disclosure requirements along the entire range of intermediaries in the lending and investment chain, to improve transparency around the due diligence relating to ESG factors and risks, as follows:

- The financial industry and firms should be required to publicly disclose via their annual reports their exposure to financial and non-financially material ESG factors and risks and how they are exercising due diligence to avoid, minimise and mitigate them;
- Such disclosure should be fully mandatory, and implementation should be independently verified, rather than self-assessed.

c) Robust accountability mechanisms are introduced by EU institutions, particularly Supervisory Authorities,
to ensure that this model of ESG factor and risk due diligence and disclosure is comprehensively implemented by financial investors. Where failings are identified, there should be opportunities for policy revisions, procedures for penalising instances of noncompliance, and a transparent grievance mechanism for third parties to bring complaints.

B. European Green Bond Standards

(Authors: Sebastien Godinot and Julia Linares (WWF))

We recommend the Commission to set up official EU green bond standards in the course of 2018. We believe there are several critical elements needed to help the green bond market to maintain and enhance its credibility and grow significantly.

Recommendations

- Green bond standards should cover and address all critical environmental challenges and expand to sustainability (i.e. including social) as a second step
- They should be science-based, long-term oriented and resilient;
- They should build on an EU official, granular green taxonomy to determine what is green;
- They should include standardised disclosure to demonstrate actual environmental benefits;
- They should include periodic reporting on environmental impacts of the underlying assets, including checking that the effective use of proceeds complies with the Green Bond standard granted upon issue, and the withdrawal of the Green Bond denomination if the effective use of proceeds is found not to comply;
- They should include a second party review;
- They should include independent third-party assurance and accreditation;
- They should include standardised certification for accredited verifiers;
- Existing initiatives can provide shortcuts and help close existing gaps in the meantime (for example Climate Bond Initiative, Green Bond Principles, etc.)

In addition, much concern remains over the additionality of green bonds and whether they help to finance new green projects or not. More information is needed throughout the whole bond market to become able to assess the additionality of green bonds - and also to avoid focusing only on a green bond niche and aim to mainstream it in the whole bond market and assess the real economy impacts. We therefore recommend the Commission to require minimum sustainability disclosure for the whole EU bond market.
The European Commission's intention to put forth a legislative proposal to clarify the duties of investors as those pertain to environmental, social and governance considerations is a necessary development in ensuring a regulatory and cultural shift towards long-termism. Such a proposal would provide a legislative framework which would encourage the alignment of the time horizons of asset managers and asset owners with those of the end investors of their institutional clients (in the case of asset managers) or direct beneficiaries/retail clients (in the case of asset owners). Building on our previous recommendations (17), as well as ShareAction's research on the topic (18), we believe such a proposal should seek to address, inter alia, the following:

1. How reporting requirements set out in sectoral regulation, such as under MiFID II, would interact with such a legislative proposal. Annual, ad hoc, or quarterly reporting requirements must be streamlined under such a proposal in order to ensure that they don't disincentive the proper discharging of the proposed duties;

2. A clarification that properly considering ESG issues is not limited to portfolio construction, but also extends to stewardship activities, engagement with clients and end-investors, as well as disclosure of ESG-related activities to beneficiaries, clients, regulators and the public;

3. A clarification and parameters within which financial detriment to the performance of a portfolio is acceptable in the short and medium term, upon proper alignment with the long-term interests of beneficiaries;

4. A clarification of what the best interests of beneficiaries entail, including a clear definition of how ESG factors may relate to those interests, i.e. through financial materiality, as well as ethical or non-financial relevance (19);
INTRODUCING KEY ELEMENTS OF AN OMNIBUS LEGISLATIVE PROPOSAL ON INVESTORS’ DUTIES .02

The following text is meant to provide an overview of minimum requirements under four key components of investors’ duties, as those relate to ESG issues: defining the best interest, ascertaining beneficiary or client views, disclosure and accountability, and conflicts of interest. Investors must take adequate steps, including through the drawing of appropriate mandates, to ensure that all their delegates and consultants also discharge the following duties:

1. **Duty to act in the best interests of end-investors**
   In the performance of any investment functions, including but not limited to, portfolio construction and stewardship activities, an investor must act in a way that would, in good faith, promote the best interests of the end-investors as a whole. In order to do so, investors must consider the following, in accordance to the time-frame of their beneficiaries or of beneficiaries of their clients, when those clients are themselves institutional investors:
   (i) The impact of any investment activity on the financial system and the economy;
   (ii) environmental, social and governance factors, including their impact on the investment and the impact of investment activities on communities and the environment;
   (iii) the implications of investment activities on the beneficiaries’ quality of life, and
   (iv) the views of beneficiaries, including ethical views, on environmental, social and governance factors.

2. **Duty to ascertain beneficiaries’ views**
   (i) An investor shall take all reasonable steps to ascertain the views of beneficiaries in relation to all matters pertaining to investment functions (and in particular, any views of the investment strategy as it relates to environmental, social and governance factors, as well as the exercise of shareholder rights);
   (ii) an investor shall have discretion as to the procedure adopted to comply with the aforementioned duty, but may choose to do so by direct consultation or dialogue with beneficiaries, or with their elected or appointed representatives and, in the case where the investor does not have beneficiaries, it should seek to ascertain these views from the intermediary to whom it directly owes duties, such as a pension fund or insurance company when the investor is an asset manager;
   (iii) an investor must act to prioritize or balance various views or concerns amongst beneficiaries and, in the case of opposing views, may adopt what is considered to be the most widely held or expressed view, provided that, in relation to non-financial ESG factors, the adoption of a particular view would not risk significant financial detriment to beneficiaries.

3. **Duties of accountability and transparency**
   (i) An investor shall be under the duty to account for and disclose all of its investment activities,
and do so transparently in that regard, including as those relate to environmental, social and governance issues, be they financially or non-financially material. This should include information on which ESG issues are taken into account, which are not, and the reasoning behind this decision; (ii) an investor must comply with all reasonable requests for information relating to the performance of its investment functions.

4. **Duties to avoid conflicts of interests**
   (i) An investor must take all reasonable steps to avoid situations in which the investors’ interest may conflict with the interests of end-investors;
   (ii) in the event of an actual or possible conflict of interest between an investor and end-investors, the investor shall, as soon as possible, disclose the conflict to the person or persons to whom the duty is owed and shall manage the conflict in the sole interest of the end-investors;
   (iii) short-term remuneration incentives for investors, their employees, delegates may constitute actual or possible conflicts of interest, and should be examined against the previous duties set out in this text.
Overall, the creation of a sustainable financial system is predicated on the availability of reliable and meaningful corporate disclosure on ESG-related factors. To this end, the Commission needs to ensure that the upcoming review of the Non-Financial Reporting Directive (NFRD) serves as an opportunity for the development of robust ESG metrics, ideally by sector, as well as reliable processes for the evaluation of ESG-related risk. These processes would, in turn, encourage investors to productively engage with company boards on sustainability issues, as well as inform their overall stewardship activities. Clarifying the duties of company directors and investors is a significant additional step in ensuring that companies are protected from the dictate to maximise short-term shareholder value.

Disclosure of (long-term) sustainability risks across the entire investment and lending chain
We welcome the HLEG final report’s recognition of disclosure as a significant enabling force in the creation of a sustainable financial system. To build upon the results of existing initiatives for increased transparency on climate risks, as recommended, is a straightforward way to go. For this purpose, the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), as well as the experience with Article 173 of the French Energy Transition Law, are to be taken as a starting point.

Introduce mandatory sustainability risks disclosure as soon as possible
Building on voluntary disclosure, the HLEG’s recommendations fall short of sufficiently highlighting the necessity of mandatory disclosure for all financial market actors. The group’s cautious approach to ensure a smooth transi-
tion is understandable, but delays could be counterproductive and risk further inefficient allocation of capital and an ever-widening sustainability gap to close. Voluntary approaches have not sufficiently induced transformative change across large parts of the markets and scale needed. Therefore, it is not plausible that comprehensive disclosure, in terms of risks addressed and the degree of market actor coverage, can be achieved voluntarily. Only if all big companies and financial institutions disclose climate-related risks and opportunities of a sustainable, well below 2°C compatible transformation, meaningful and consistent information will be available to drive sustainable investment and to create a level playing field. About 1,600 European companies have already adopted forward-looking climate disclosure and will as of 2018 be requested to disclosure compliant with the TCFD recommendations (20), and more than 230 companies (21) globally support the TCFD recommendations. Many of these businesses (22) have been vocal in their support for mandatory reporting in line with the TCFD recommendations and a number of companies has committed to implement the TCFD recommendations within the next three years (23). Those companies see reporting as an opportunity to receive more, long-term investment, which will allow them to transition to a more sustainable business model.

Systematically implement forward-looking perspectives

In order to induce the sustainable transformation of the economy and to manage related opportunities and risks, a paradigm change from observations of the past towards forward-looking analysis is necessary. This could have been mentioned in a more explicit, operationalised manner.

Use disclosed information to systematically account for the actual contribution of investments and capital allocation decisions to achieving societal goals

So far, no systematic evaluation exists to this end. Most prominently, Article 2.1.c of the Paris Climate Agreement asks all member states to align all financial flows with the goals of the agreement. However, due to the lack of a comprehensive approach, Art. 2.1c is insufficiently implemented. Reporting obligations should explicitly encompass the contribution to societal goals.
The European Commission should start implementation of the TCFD recommendations now and we see the upcoming review of the NFRD as a perfect opportunity to do so. This strong signal will give a clear message to the business community and speed up the process to achieving the goal of a financial system that can provide levels of investment required for a sustainable future while giving business time to experiment and prepare. It is important that when taking the next steps, the Commission and the member states still need to take additional action to close remaining gaps and improve on some aspects of the recommendations.

1. The review of the NFRD in 2018 and its transposition into national laws crucial for the EU’s ability to deliver, by 2020, a comprehensive and useful EU climate-disclosure regime, compliant with the TCFD recommendations and ensuring an EU level playing field by harmonising climate reporting. The review should result in mandatory TCFD reporting requirements by 2020 at the latest, which would allow for businesses to prepare over a reasonable period;

2. Ensure forward-looking, standardised, meaningful and comparable disclosure by - through the review of the NFRD - specifying disclosure requirements through setting up a few Key Performance Indicators for all sectors and sector-specific KPIs to report key ESG issues. They are critical to ensure strategic reporting on the most important issues by sector, ensure comparability between peers, and streamline reporting requirements to substantially limit reporting costs. The Commission’s non-binding guidelines of the NFRD can serve as a starting point to work out meaningful climate-related KPIs such as “well below 2°C standardised scenario for forward looking climate scenario analysis”, “adoption of a Science-Based emission reduction Target”, “sourcing from renewable energy” and “usage of an internal carbon price”. With respect to human rights, the NFRD requirements should build on the UNGP (24) Reporting and Assurance Framework (25). The contribution to societal goals should particularly be reflected in some KPIs and reporting obligations in line with the SDGs.

3. Multi-stakeholder groups should be convened by the Commission at sector or subsector level with a one-year mandate and the aim to define a limited set of KPIs for the most meaningful and strategic possible ESG reporting. We also encourage the Commission to build on “disclosure learning and leadership” resources and best-practice guidance already available and used by the market (26);

4. The International Organization of Securities Commissions (IOSCO) should be urged to issue a recommendation that listing requirements from stock exchanges integrate TCFD requirements for listed companies. This is critical to ultimately ensure a global implementation of the TCFD recommendation - not limited to the EU;
The European Commission presented on the 20th of September the “ESAs package” to strengthen the supervision of the European financial markets. An important sustainability element is that it explicitly includes a part on “Integrating sustainable finance considerations into financial supervision”, and related proposals for regulatory amendments.

This ESAs package was substantially influenced by the discussion occurring in the EU High-Level Expert Group on Sustainable Finance, which included an early recommendation in its Interim Report on “Positioning the European supervisory agencies on sustainability issues”.

OUR RECOMMENDATIONS .02

We recommend the European Commission to:

1. **Clarify the ESAs mandate:**
   - Make explicit that material ESG-related risks are included in their mandate;
   - Clarify concepts and objectives (sustainability, ESG, etc.), to ensure that no relevant ESG-related risk is omitted; this should include but not be limited to climate change;
   - ESAs should also encourage a certain percentage of representatives in stakeholder groups to have exper-
tise on sustainability issues in the financial sector.

- Make sure that national supervisory authorities address sustainability risks in their systemic risk assessments and use the tools at their disposal to actively address the issue (e.g. countercyclical capital buffers are set at 0% by Eurozone member states, while other EU member states actively use it - UK and Sweden for example)

2. PRIORITY: Ensure that ESAs put in place a monitoring system to assess material ESG risks:

- We welcome the HLEG recommendation to extend the focus beyond the usual two- to five-year timeframe when supervising risk management systems, and to develop tools to gauge long term risks and avoid systemic mispricing by financial markets.
- The monitoring system should start in 2018 with forward looking climate scenario analysis: several national financial regulators are already performing or preparing such assessments. Such initiatives should be rapidly mainstreamed at EU level and should become a mandatory component of national supervisory authorities’ duties. Importantly such analysis should build on standardised climate scenarios, including a well below 2°C scenario, to check portfolio alignment with the Paris Agreement and the climate-related value at risk. This will ensure consistency with the TCFD recommendations. ESAs should also issue guidance to financial institutions on how to use forward-looking climate scenario analysis.
- It should then be extended to other significant material ESG risks as soon as possible.

3. Ensure that ESAs will monitor and check the consistent implementation of ESG integration by financial institutions

A mapping of potential changes in existing level 2 and 3 regulations should be done to avoid gaps. As recommended by the HLEG, the supervision of how regulated entities consult their beneficiaries and reflect non-financial preferences into investment strategies should feature the ESAs supervision. Updating several ESAs guidelines will very likely be necessary.

4. Apply sustainability test to any new financial regulation

As committed to in the CMU mid-term review, the Commission should apply a sustainability test to any new financial regulation, and ensure that ESAs’ guidelines integrate ESG-related issues accordingly.
BANK CAPITAL REQUIREMENTS AND THE CASE FOR A MACROPRUDENTIAL APPROACH OF CLIMATE RISKS

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OUR ANALYSIS .01

Recently Vice President Dombrovskis of the European Commission raised the possibility of introducing a ‘green supporting factor’ (GSF) in the micro-prudential banking framework in order to “boost green investments and loans” by lowering capital requirements for certain climate-friendly investments. In this short note we argue this would not be the best way to proceed and that attention should focus not on a micro but on a macroprudential approach to climate risks.

The introduction of a GSF would follow the precedent of the 25% SME supporting factor introduced in 2014 by the EU to bolster loans to SMEs. Microprudential risks weights are supposed to reflect the level of risks of a single credit and the SME supporting factor was adopted on the basis that credits to SMEs could be on average less risky than other credits. There was no decisive evidence of that (see EBA report (27)), but SMEs were given the benefit of doubt. Is there merit in applying the supporting factor approach to green credits?

We think not, for 3 main reasons.

First, risks weights are overwhelmingly determined by banks on the basis of internal rating models, as the regulation permits (28). Therefore if some credits are considered by the bank to be less risky nothing prevents a bank from lowering its capital requirements for certain credits.
Second, while credits to SMEs are a well identified category, with a long history, green credits are still to be defined and are a new area for lending. It would therefore not be possible to justify a capital requirement discount on evidence-based arguments that green credits are less risky.

Third, the proposed change comes down to reducing banks prudential capital. Even though the amount is likely to be small, this goes against the views of many, including academics and Civil Society Organizations (CSOs), that to make a more resilient banking sector banks should hold more prudential capital, not less.

Fourth, the case of green credits differs fundamentally from that of SME credit on one more crucial point. Whatever their future definition, the purpose of green credits should not be to pile up green finance on a brown economy. The transition to a sustainable economy does not mean simply investing more in renewable energy or any other « green sector », but shifting financial flows so that zero net emissions can be achieved as soon as possible, at least by the end of the century.

If the Commission intends to consider introducing a green supporting factor, this option should be explored only if accompanied by a brown penalizing factor.

However, it needs to be noted that the risks of carbon intensive investments are not, in the current economic framework, risks to the credit worthiness of an individual credit. In a world where carbon emissions are generally not priced, a single credit is still, sadly, no more prone to default whether the borrower generates a lot of carbon emissions in the future or not.

We understand that the issue of pricing carbon and other negative externalities is not in the remit of the HLEG or the DG FISMA. We cannot however but recall the simple fact that finance cannot be sustainable unless the assets it finances are sustainable: so, we urge the Commission to tackle this central issue, and show its leadership by embarking on a really green and sustainable economic policy, of which sustainable finance is only one component.

We would also like to suggest that, while there may be no threats to the credit worthiness of a given carbon intensive credit in the current economic framework, there is a case that this credit may pose threats to the stability of the financial system at a macroprudential level. Physical, transition and liability risks have been outlined by Mark Carney (Governor of the Bank of England and Chairman of the G20’s Financial Stability Board) in his famous “Tragedy of the horizons” speech from December 2015, and have since laid ground to the work of the Task Force on Climate-related Financial Disclosures (TCFD).

Central Banks have started to look at the risks of climate change to their domestic financial systems, and a group of Central Banks has been set up to look transversally at the issue (Central Banks and Supervisors Network for
Greening the Financial System). While the economics conditions may not warrant a clear understanding of the climate change threats and opportunities at individual credit level, there may be sufficient evidence in the making to address the transition issue at the macro, rather than micro, prudential level.

Rather than a green supporting factor that will weaken banks and fail to address the real issue, that is the amount of credit that contributes to raising CO2 equivalent emissions, we would favor the consideration of an additional "transition risks" capital buffer, covering the three risks outlined by Mark Carney, at the macroprudential level.

In order to adequately calibrate the size of this buffer, we would encourage Central Banks, as major holders of securities, to apply to themselves the recommendations of the TCFD, and to start measuring the current and future alignment of their securities portfolios with the Paris Agreement. Among crucial Central Bank’s policies are the ‘eligibility criteria’ of the asset purchase programs. Introducing progressively lower carbon and climate alignment criteria in these could also be a quite efficient way of ensuring a smooth transition, much better than relaxing capital requirements in the microprudential framework.

OUR RECOMMENDATIONS .02

1. We invite the Commission to tackle the central issue of carbon and negative externalities pricing;
2. We strongly suggest the Commission maintains a risk-based approach in its prudential framework;
3. We invite the Commission and the ESFS to consider an additional «transition risks» capital buffer;
4. We encourage the Commission to collaborate with the ECB and the national CBs in order to start measuring the current and future alignment of their securities portfolios with the Paris Agreement;
5. We encourage the Commission to examine to what extent an alignment of the eligibility criteria of the asset purchase programs would have a positive spillover on the allocation of capital towards sustainable investments.
CORPORATE GOVERNANCE AND DIRECTORS DUTIES

The HLEG encouraged the European Commission to open a policy discussion on the corporate governance principles for both financial actors and public corporations. Corporate governance may be broadly understood as the way corporations are administered and structured, by whom, by what and for whom (which purpose). From the 1970s onwards, mainstream corporate governance models have narrowed until the purpose of the corporation has become equated with the maximisation of shareholder value (29). This has lead companies to prioritise short-term profits at the expense of innovation, sustainability, and employee and societal well-being. This is mostly done by raising the proportion of corporate profits spent on dividends and share buybacks, by engaging in mergers and acquisitions, and by externalising costs.

This model has also contributed to a race to the bottom in wages in the EU and to exploitative conditions in global supply chains. The efforts to promote sustainable finance therefore require a proper consideration of the influence of short-termism and shareholder primacy in corporate governance theory and practice; otherwise the effectiveness of this endeavour on the real economy would remain limited.

OUR RECOMMENDATIONS .02

1. Clarify company directors’ fiduciary duties and incentives

Directors have a fiduciary duty to act in the best interests of ‘the company’. However, in practice this duty is often misunderstood to compel directors to prioritise maximising shareholder value, even to the detriment of the company’s long-term prospects or societal interests (30). This complicates boards’ and investors’ engage-
ment with ESG-related risks which are beyond the time horizons typically considered by capital markets. We recommend the EU to take following actions with respect to directors’ duties and executive remuneration:

• Specify that the duty of directors includes to (a) ensure success of the company as a whole; (b) assess and report on environmental and social risks connected to the business of their corporation; and (c) report on how systemic risks and salient negative impacts on corporate stakeholders and society at large will be mitigated;
• Provide a definition of what the success of the company means, building on the concept of multiple-capitals that is described in the International Integrated Reporting Framework (31) and advocated by the South African King IV Report (32).
• Clarify that directors’ duties are owed to the company (33) rather than the shareholders. The company should act to the benefit of all interests it represents (including shareholders, employees, community, the environment, etc.), but first and foremost the directors must act in the best interest of the company as a separate legal entity (34).
• Recognize the conflict between the perspectives and timeframes of different types of shareholders (and that of the company) and offer suggestions to boards as to how to address it.
• Clarify how boards should approach the issue of natural capital. Many natural resources are essential to life, and have no substitutes, and therefore should not be depleted or converted as freely as other types of capital. The EU action should in this respect should build on the concept of planetary boundaries and encourage or require directors to steer their company’s business model towards environmental sustainability as an essential aspect of promoting the long-term success of the company.
• Require decoupling KPIs and incentive structures, and specifically share-based remuneration, from short-term objectives and financial metrics and link them to long-term strategic goals of the company;
• Enable employees to express their views and engage with executive compensation schemes.

2. Support the influence of patient capital and responsible investors
Shareholders, and in particular institutional investors can substantially influence corporate strategies and their engagement represents an opportunity to foster patient capital and support long-term sustainable value creation. However, in practice, companies and patient investors often encounter the problem that their influence is outweighed by short-term traders. There are several options to strengthen the impact of patient capital:
• Encourage use multiple classes of shares to vest voting rights with committed shareholders;
• Allocate rights and incentives to investors on the basis of the length of shareholding or contribution to the corporation’s capital, including in takeover scenarios;
• Allow the setting up of defensive structures to enable protection against takeovers (35);
• Provide for the rights of and means for engagement with institutional investors by end beneficiaries (36);
3. Elaborate stronger guidance in corporate reporting and accounting models

Current accounting and corporate reporting models focus primarily on short-term financial information, which complicates the integration of multiple capitals in business evaluation. Recommendations to engage with this situation include:

- Accounting, reporting, and valuation models for non-financial capitals and ESG issues need to be further developed, harmonized and integrated with financial accounting;
- Elaborate in detail the key systemic matters that companies are required to report on in the Non-Financial Reporting Directive, relevant to specific industries and companies business models;
- Clarify that the concept of materiality in non-financial reporting includes three dimensions (1) the system (i.e. environmental and social issues) (2) the company (i.e. future financial risks or any specific social or environmental goals of the company) and (3) the stakeholders, notably including the shareholders;
- Provide requirements and guidance on monitoring and enforcement in the legislative instruments that have been adopted so far to support non-financial reporting, including a requirement for independent verification.
CREDIT RATING AGENCIES

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OUR ANALYSIS .01

Credit rating agencies are critical actors in establishing and maintaining market norms on financial management and governance by issuers in debt capital markets. While the credit rating is an essential market tool, it is currently not integrating long horizon risks or the influence of disruptive ESG trends on issuer’s future credit worthiness.

Credit rating agencies partly have a public good role by providing credit ratings to investors and lenders in European markets; such a public good role should be consistent and aligned with the EU sustainability objectives. However, despite incremental progress credit ratings agencies do not yet properly integrate sustainability factors. Reforms are needed to ensure that they assess and integrate longer term sustainability factors.

OUR RECOMMENDATIONS .02

We recommend the European Commission to:

1. Clarify how credit rating agencies integrate ESG factors in credit ratings methodologies:
   - More disclosure requirements for credit rating agencies on their methodologies;
   - Monitoring of supervisory authorities of credit rating agencies on the systematic integration of ESG factors and longer timeframe of risk assessment in their methodologies;
   - Specifically, requirement for credit rating agencies to communicate whether the issuer’s reporting is aligned with TCFD recommendations;
• Requirement to demonstrate the ESG competence of staff to the supervisory authorities;

2. Ensure credit rating agencies provide longer term sustainability information that investors and lenders need for sustainable investing and lending:
   • Require credit rating agencies to integrate longer term sustainability factors in “rating outlooks” – well differentiated from ratings – that apply to all European issuers, showing how a given issuer is exposed to long term ESG risk;
   • Require credit rating agencies to use their privileged access to issuer information to collect and provide additional ESG information to lenders and investors, notably on issuer’s alignment with TCFD recommendations.
OUR RECOMMENDATIONS .02

We recommend the European Commission to:

1. Require investors to explicitly consider and disclose to what extent their investment beliefs on environmental, social and governance factors have been reflected in their choice of index, both for active and for passive strategies. When opting for passive options, sustainability indexes should be considered for default funds. This should notably apply to the IORP II Directive (37) and the new Pan-European Pension Products (38).

2. PRIORITY: Corporate disclosure is not sufficient for proper capital allocation: the HLEG highlights the need for disclosure at product level. This includes benchmark disclosure, as benchmarks are a major driver in financial markets. Disclosing the implicit ‘climate bet’ of mainstream benchmarks (ie if they align with a 2°C, 4°C or 6°C climate scenario) is critical to raise awareness of investors, help them to gradually reallocate their investments in a more sustainable way, and generate investor demand towards index providers to create 2°C aligned benchmarks. This HLEG recommendation has a huge potential to help gradually align investments with the Paris Agreement.

3. To our knowledge two methodologies at least are already available to do such assessments (39) - including
at very low cost, which confirms the feasibility and ability to implement such assessments and disclosure.

4. The HLEG makes clear that this disclosure should focus on large benchmarks not only on the niche of sustainability benchmarks and on their sustainability impacts not only on their methodology.

5. Require for passive funds that there is detailed disclosure of the methodologies, including full details of whether and how sustainability is integrated into the methodology. This should be included in the Key Information Document (KID) through delegated act (40).

6. Ensure that the ESMA will include ESG considerations in its guidance on the “Benchmark statement”.

In Europe retail investors hold over 40% of financial assets or €34 trillion (Eurostat). This has a massive potential to contribute to the achievement of the EU 2030 climate and energy targets and the Paris Agreement overtime.

OUR RECOMMENDATIONS .02

We recommend the European Commission to:

1. **Ensure the climate impact of retail funds is disclosed**
   It is critical to raise awareness of retail investors and fix the massive disconnect between their high non-financial sustainability interests and the small retail market for sustainable/green/climate funds. Such disclosure will ensure better-informed investment allocations and improve their consistency with retail investors’ preferences. The same methodologies available for benchmarks (please see ‘Benchmark’ section above) can be used for retail funds. Overtime, wider sustainability impacts of retail funds should be disclosed with new/more impact assessment tools becoming available.

2. **Require investment advisers to ask about and respond to sustainability preferences of retail clients.**
   This HLEG recommendation is critical to fix the significant gap between the large majority of retail investors claiming to be concerned about sustainability issues and the limited response by financial advisers in term of sustainable investment offer. The Commission should integrate it in the MiFID regulation or relevant delegated act(s).
THE SOCIAL FACTOR AND LABOUR RIGHTS

OUR ANALYSIS .01

The financial industry is competence-intensive with skilled workers and a catalyst to the green transition. A strong and innovative financial sector can contribute to creating green jobs and limit the outsourcing of key competencies. Investments in research, professional development and production of green financial services will be imperative in the years to come.

It is crucial that the players in the financial industry are competent and updated on how ESG-themes affect investment, society and customers. Education on sustainability and accountability must be part of different training and competence programs, which should be a natural part of company-based training for employees. Furthermore, organized labour should be allowed to play a key part as provider of knowledge about accountability and sustainability. Union representatives and employee representatives in boards are well placed to carry the message of sustainable finance in their companies.

Capital is a crucial tool for change towards a more sustainable European economy. A regulatory framework that stimulates innovation and encourages business development must be aligned with the proper tax incentives to make change possible.

Measures to assess the social impact of investments go hand in hand with efforts to address environmental concerns and climate change. Both in Europe and globally, labour rights and trade union rights are being put under increasing pressure from corporations and investors. Social dialogue and collective bargaining is being undermined across Europe and globally, with notable examples from recent months in Estonia, Slovakia and the Czech Republic. The European Commission’s own refusal to make binding the social dialogue agreement on occupa-
tional health and safety in the hairdressing sector is another regrettable case in point (41). Many more examples can unfortunately be raised.

The tendency of undermining collective bargaining threatens the stability of labour markets as it reduces the ability for social partners to find common solutions to the need to adapt to future challenges. Moreover, it weakens wage earners’ bargaining power and wage development to the detriment of the purchasing power in general putting demand-driven growth under pressure. Thirdly, it weakens countries’ and regions’ capacity to handle the effects of globalization and technological change. This in turn increases inequality of income and opportunity both among different social and age groups and between different areas and regions.

The financial sector with its massive assets under management has a key role to play in addressing these concerns and it is therefore vital that the social perspective goes hand in with environmental and governance aspects. The EU commitment is clearly articulated by the TFEU article 151: “The Union and the Member States […] shall have as their objectives the promotion of employment, improved living and working conditions, so as to make possible their harmonization while the improvement is being maintained, proper social protection, dialogue between management and labor, the development of human resources with a view to lasting high employment and the combating of exclusion”. We expect the HLEG to take this broader perspective into account.

The recommendations from the HLEG should strive towards integrating environmental and social concerns, and include labour factors as a key element in a future classification system and policy for sustainable finance.

OUR RECOMMENDATIONS .02

The financial industry should look to authorities to facilitate debate around ethical considerations and facilitate dilemma training for employees, including integrating ESG into all sector specific training programs.

Transparency on the social impact of investments is urgently needed and metrics should be developed to support this aim. First, certain investment decisions may have profound impact on local employment in an area or region, both positively and negatively, and investors have a right to access this information. Secondly, a financial investment into any given institution may, just as with environmental aspects, impact social factors. For example, the actions of a certain companies or sector may be in breach of the right of collective bargaining, the freedom of association or the right to strike, acknowledged both in ILO Conventions and the EU Charter on Fundamental Rights, or undermine social dialogue.

In line with the above, classifications or standards of sustainability should entail minimum standards on labour rights. The ShareAction Workforce Disclosure Initiative is an interesting example in this regard. Any such initiative
would also imply that, regardless of the design of the framework and the powers invested in the administrator, there must be no worsening of employee’s rights in any aspect due to an investment or due to a transition to intelligent and green banking.

Finance employees are key levers to facilitate the transition to green finance. A continuously sound and sustainable employment situation is a prerequisite. This includes but is not limited to: ensuring training and professional development with regard to green finance, taking into account differences in business models and national practice; providing time and resources for finance employees to provide good advice and exercising their fiduciary duty including integrating ESG factors in the cost-benefit analysis. Tailoring legislation of the financial sector to facilitate long-term prosperity and stable returns.

Customer-facing staff enhances customer satisfaction in terms of both service and experience - two key aspects that protect the consumers’ trust in the sector which in turn stimulates financial stability and transitions to green investing. Moreover, as robo-advice and fintech becomes more common they bring services to geographic locations that before could not be reached. On the flip side, the increasing possibility to monetize human advice risks escalating into pricing that excludes small and medium size investors that will not afford to pay for it. This in at a time where the OECD reports (2017) that financial literacy is worryingly low, and in a disharmonized financial system where the diversity of impact standards can be confusing. This is why affordable and equal access to financial services, including human advice, should be at the top of the sustainability agenda.

In general terms impact assessments analyzing the effects on employees must be made when drafting new EU legislation including measures on sustainability.

In addition, the mandate of the ESAs need to be revised, strengthened and clarified in order to enforce the social factors as described above.
ENDNOTES

1. High-Level Expert Group on sustainable finance, January 2018, Financing a Sustainable European Economy
2. The Global Deal
5. For example, see: reports: FoEE (2015) Up in Smoke: Failures in Wilmar's promise to clean up the palm oil business Global Witness (2013) Rubber Barons. How Vietnamese companies and international financiers are driving a land-grabbing crisis in Cambodia and Laos; and RAN (2016) The Human Cost of Conflict Palm Oil (pg10)
6. For further information on the details of the financially material risks involved, see Rainforests Action Network (2017) Every investor has a responsibility: a forests and finance dossier, https://www.ran.org/forests_finance_dossier
8. A recent example of this is the reported cancellation on 31st August 2017 of 20,000 hectares of rubber plantations in Cambodia by the Royal Cambodian Government, which had been owned by four Vietnamese agricultural concession companies
11. For example, see the varying ESG requirements included in the Shareholder Rights Directive, Institutions for Occupational Retirement Provision (Pension Funds) Directive and the Alternative Investment Fund Managers’ Directive.
12. For example the Shareholder Rights Directive Article 3g(1)
14. UNEP Inquiry (2015) The financial system we need – aligning the financial system with sustainable development
15. For further information, see https://sustainabledevelopment.un.org/post2015/transformingourworld
16. As referenced in the European Commission’s consultation on investor’s duties (2017)
19. A useful distinction was proposed by the UK Law Commission’s 2014 Review of the Fiduciary Duties of Investment Intermediaries.
28. The largest banks, with the biggest loan books, use the internal models approach which allows them to model their own risks – subject to controls internally and by regulators and supervisors.
30. See Modern Corporation Project, Statement on Company Law. Available at https://themoderncorporation.wordpress.com/company-law-memo
31. The International Integrated Reporting Council, The International <ir> Framework (13 December 2013), available at http://integratedreporting.org/resource/international-ir-framework/ In this concept, the capitals are stocks of value that the company uses or affects and depends on for its success.
38. Proposal For A Regulation Of The European Parliament And Of The Council On A Pan-European Personal Pension Product (PEPP)
39. The Sustainable Energy Investment Metrics methodology has been developed by an Horizon 2020-funded research programme of nine organisations and led by 2° Investing Initiative. Summary of the Sustainable Energy Investment Metrics project: http://2degrees-investing.org/fr/fr/#/page_resources; Presentation of the project: https://prezi.com/otrqbdpsvmr/prezentation-of-the-sei-metrics-research-project-fabien/. Presentation of the methodology: https://prezi.com/embed/mn9v1fmCGWm/bgcolor=ffffff&lock_to_path=0&autoplay=no&autohide_crls=0&features=undefined&disabled_features=undefined. Separately, Mirova developed a methodology in Mirova Responsible Investment Research (2017), Estimating Portfolio Coherence with Climate Scenarios
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