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Fondazione Eni Enrico Mattei

Brief

Transforming the EU Financial Sector into a Powerful Actor in Promoting Sustainability

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Abstract

FEEM Policy Brief

At the beginning of January 2019, the Technical Expert Group on Sustainable Finance set up by the Commission in July 2018 has issued its first report on companies' disclosure of climate-related information. It includes a set of instructions that will lay the foundations for the Commission to reform its voluntary guidelines on non-financial reporting (2014/95/EU). Furthermore, the European Commission has unveiled a series of draft rules on how investment firms and insurance distributors should account for sustainability issues when advising their clients. These recent announcements are part of the Commission's Action Plan on Financing Sustainable Growth, which represents one of the pivotal steps towards the implementation of the Paris Agreement pledge and the EU's agenda for sustainable development.

01 Introduction

The EU is committed to "a development path that meets the needs of the present without compromising the ability of future generations to meet their own needs" (European Commission, 2018c: 1). Achieving EU sustainability goals implies considerable investments. Specifically, to keep global warming to well below 2 degrees, over the next decade Europe requires additional annual investment of the order of €180 – 270 billion, an amount public finance on its own will not be able to deliver. This means that the private sector is to contribute the largest share of the overall climate financing needs. Closing this investment gap requires a comprehensive rethinking of the European financial framework that could redirect private capital flows towards more sustainable investments (European Commission, 2018b). There are two main compelling arguments for promoting a greener functioning of the financial sector. Firstly, the impact of climate change already threatens financial stability and causes considerable economic losses through floods, land erosion or draughts. As a case in point, catastrophe-related losses covered by insurance reached an all-time high in 2017 of the order of €110 billion (European Commission, 2018d). More generally, economic losses from extreme weather disasters have risen by 86% between 2007 and 2016 (ibid). Secondly, it has increasingly become clear that failing to respond to the reality of global warming implies that many today's investments could end up being redundant. For these reasons, transitioning to a low-carbon and more resource-efficient economy, whilst securing the stability of the financial system, is fundamental to the long-term competitiveness of the EU economy.

To this end, the Commission established in December 2016 a High-Level Expert Group (henceforth HLEG) to develop a EU strategy on sustainable finance. The HLEG issued its final report on 21 January 2018 highlighting what have been identified as two imperatives for Europe's financial system. The first is to strengthen the role of finance in promoting sustainable and inclusive growth. The second is to deliver greater financial stability by integrating Environmental, Social and Governance (henceforth ESG) factors into investment decisions.

02 Legislative context

Suitability Assessment

MiFD II became applicable on 3 January 2018 and, combined with Regulation (EU) No 600/20142 (MiFIR), succeeded Directive 2004/39/EC. MiFID II and MiFIR define the legal framework establishing the requirements applicable to investment firms, regulated markets, data reporting services providers and third country firms providing investment services or activities in the EU (European Commission, 2019a). Together, they attempt to improve the efficiency, resilience and integrity of financial markets.

Within the existing framework, firms providing investment advice and portfolio management are required to obtain the necessary information to carry out suitability assessments. These include information about the client's knowledge and experience in the investment field, their ability to bear losses and their targets. Nonetheless, the information about investment goals generally refer to financial objectives, whereas non-financial objectives of the client, such as ESG preferences, are usually not taken into account (European Commission, 2019a). Existing suitability assessments generally do not include questions on clients' ESG preferences and evidence show that most clients do not raise ESG issues during the advisory process themselves (European Commission, 2019a: 4). As a consequence, investment firms consistently do not take account of ESG factors in an appropriate manner over the current selection process.

ESG-related disclosure

In the Action Plan (Article 9.2), the Commission also engaged to revise the non-binding guidelines (NBGs) of the Non-Financial Reporting Directive (NFRD) governing disclosure of ESG-related information with the aim to improve disclosure of climate-related information by enterprises. More specifically, Article 9.2 states that NBGs will be amended to "provide further guidance to companies on how to disclose climate-related information, in line with the Financial Stability Board's Task Force on Climate-related Financial Disclosure (TCFD) and the climate-related metrics developed under the new classification system" (European Commission, 2018a). Climate-related information represents a critical contributor to efficiently directing private capital towards investments that drive solutions for climate change mitigation and adaptation. Providers of capital require information on the risks and opportunities companies face due to climate change, and how they contribute to or help mitigate impacts on climate change, to make well-informed financial decisions. In fact, transitioning to a climate-neutral EU economy implies that a wide range of carbon-intensive assets may become stranded (in other words unusable).

NFRD lays down the rules on disclosure of non-financial and diversity information by large companies (European Commission, 2017). Such directive amended the accounting directive 2013/34/EU. Companies are required to include non-financial statements in their annual reports from 2018 onwards (ibid). EU rules on non-financial reporting only apply to large public-interest companies with more than 500 employees (although some Member States have dropped the threshold to 250). This covers approximately 7,400 large companies and groups across the EU which comprise listed companies, banks, insurance companies as well as other companies classified as public-interest entities by national authorities (European Commission, 2019b: 6). Under NFRD, large companies have to publish reports on the internal policies they implement with regards to environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery and diversity on company boards (European Commission, 2017). Companies are given significant flexibility by NFRD to disclose relevant information according to their own judgement (ibid). Companies may use international, European or national guidelines to produce their statements – for instance, they can rely on the UN Global Compact, the OECD guidelines for multinational enterprises and ISO 26000.

03 Key Features of the Announcements

Green Investment Advice

As highlighted by the previous section, current legislation creates a divergence in how investment firms that provide investment advice and portfolio management integrate ESG considerations and preferences in their suitability assessments. This leads to uncertainties and confusion for investors. The Commission believes that in order to improve the functioning of the EU internal market and stimulate investor's demand for ESG products, the way financial actors integrate ESG considerations and preferences into the suitability assessment should be harmonised (European Commission, 2019a). This is the objective set by the Commission in issuing its recent amendments. Appendix (2) summarises the changes to the existing regulation presented in the draft report.

Climate-related Disclosure

The report contains proposals for disclosing how climate change might influence the performance of a company and stresses the importance of taking account of the impacts of the company itself on climate change. The guidelines included in the report intends to support companies in developing high quality climate-related disclosures aligned with the Non-Financial Reporting Directive and respond to the recommendations of the TCFD. Notably, a mapping of the TCFD's recommended disclosures to the elements of the NFRD is included in the report to inform the disclosure guidelines. Specific disclosures and guidance are described under each element of the Non-Financial Reporting Directive requirements[1], including metrics for all in-scope companies, for non-financial companies, and for banks and insurance companies. Nevertheless, the Commission stresses that this report was drafted under the assumption that the disclosure guidelines provided are and will remain voluntary. Stakeholders were invited to provide written feedbacks on the report by 1 February, which will be considered by the Commission in the update of the existing guidelines (2014/95/EU) prior to their planned adoption in June 2019. More detailed information on the disclosure recommendations included in the report can be found in Appendix (3).

[1] Business Model; Policies and Due Diligence; Outcomes; Principal Risks and Their Management; Key Performance Indicators.

Policy conclusions

These announcements confirm the commitment of the European Commission to make sustainable finance a reality. Notably, they contribute to set out a comprehensive strategy to further connect finance to sustainability with the aim to achieve climate neutrality by 2050. Firstly, the proposed guidance included in the report on climate-related disclosure addresses gaps in current reporting practice, allowing for comparability across jurisdictions and aligning with the EU's decarbonisation targets and streamline reporting. Secondly, the draft rules amending MiFID II and IDD should ensure that investment firms and insurance distributors can already prepare to take ESG preferences into account in their suitability assessments to verify whether their proposed investments are appropriate for their clients. The Technical Expert Group anticipated that its reports on taxonomy, carbon benchmarks and green bonds will be released by June 2019 (European Commission, 2019b). The Commission's ambition is that increased confidence in climate-related disclosures could shore up green financial products and promote innovation in sustainable investment strategies within the broader financial eco-system.

References

European Commission (2017). Guidelines on non-financial reporting. Brussels.

European Commission (2018a). Action Plan: Financing Sustainable Growth. Brussels.

European Commission (2018b). Directive 2018/0179 on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341. Brussels.

European Commission (2018c). Proposal 2018/0180 amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks 2018/0180. Brussels.

European Commission (2018d). Sustainable finance: Making the financial sector a powerful actor in fighting climate change. [online] Available at: http://europa.eu/rapid/press-release_IP-18-3729_en.htm [Accessed 22 Jan. 2019].

European Commission (2019a). Draft amending Delegated Regulation (EU) 2017/565 as regards the integration of Environmental, Social and Governance (ESG) considerations and preferences into the investment advice and portfolio management. Brussels.

European Commission (2019b). Report on Climate-related Disclosures. Brussels.

Appendix

(1) The Commission released on 8 March 2018 an Action Plan on Financing Sustainable Growth where the following key proposals have been presented (European Commission, 2018d):

A unified EU classification system (taxonomy)
Identify and define harmonised criteria for determining whether an economic activity should be viewed as environmentally-sustainable. This will lay the foundations for the future establishment of standards and labels for sustainable financial products, as noted in the Action Plan on Sustainable Finance.

Investors' duties and disclosures
Establish consistency and clarity on how institutional investors (i.e. asset managers, insurance companies, pension funds, or investment advisors) should integrate ESG factors when making investment decisions.

Low-carbon benchmarks
Design a new category of benchmarks, including the low-carbon benchmark or "decarbonised" version of standard indices and the positive-carbon impact benchmarks. This new market standard should indicate companies' carbon footprint and provide investors with further information on portfolios' carbon footprint.

Advice to clients on sustainability
The Commission committed to amend the delegated acts under Directive 2014/65/EU on markets in financial instruments (MiFID II) and Directive 2016/97/EU on insurance distribution (IDD) to ensure that sustainability preferences are taken into account in the suitability assessment.

(2) Additions to the existing regulation included in the draft proposal are reported below (European Commission, 2019a: 7):

- *In accordance with their obligation to act in the best interest of the client, recommendations to client should reflect both the financial objectives and, where relevant, the ESG preferences expressed by those clients;*
- *In order to avoid "mismatches", investment firms providing investment advice should first assess the investor's investment objectives, time horizon and individual circumstances, before asking the client for his or her potential ESG preferences;*
- *Investment firms should also explain to their clients how their ESG preferences for each financial instrument are taken into consideration in the selection process used by those firms to recommend financial products.*

These measures can only come into force once the proposal is agreed. The Commission would then officially adopt these draft measures, which will come into force — unless MEPs or EU governments object to them during a six-month scrutiny period.

(3) The report distinguishes between three types of disclosure (European Commission, 2019b):

- *Type 1 disclosures – those that companies should disclose (high expectation that all reporting companies disclose them);*
- *Type 2 disclosures – those that companies should consider disclosing (expected of companies with significant exposure to climate-related risks and opportunities);*
- *Type 3 disclosures – those that companies may consider disclosing (additional or innovative disclosures that provide more enhanced information).*

The **Fondazione Eni Enrico Mattei (FEEM)**, founded in 1989, is a non profit, policy-oriented, international research center and a think-tank producing high-quality, innovative, interdisciplinary and scientifically sound research on sustainable development. It contributes to the quality of decision-making in public and private spheres through analytical studies, policy advice, scientific dissemination and high-level education.
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