Finance Watch
Making finance serve society

Finance Watch response to the Questionnaire by the High-Level Expert Group on Sustainable Finance in relation to the interim report, published in mid-July 2017

Brussels, 20 September 2017

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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

We at Finance Watch believe that a sustainable finance is one that finances a sustainable economy. In our view, a sustainable economy is a 2°C compatible economy, in the sense outlined by the UNFCCC Paris Agreement, within a sustainable development and social framework, as outlined by the Sustainable Development Goals of the UN 2030 Agenda.

We think the first urgency for the EU policy is to give the right price to environmental externalities, starting with putting a right price on carbon emissions. The Stern Stiglitz Commission explained how such a "right" price can be designed and recommended an indicative corridor. As outlined in the report, such carbon emissions pricing needs to be accompanied by economic policies to support the transition. Such policies, if properly designed, will make investment in a low carbon economy profitable, in a sustainable manner over time. They will unlock a huge investment potential. Therefore, we think that implementing a sustainable economic policy is a prerequisite to a making finance sustainable.

But we also consider that certain issues must be addressed in the financial system itself, to make it sustainable. Among those many issues, the most pressing is the excessive leverage in the EU banking system. It is a source of instability i.e. of short termism. It also creates the threat of possible future bail in and/or bail out requirements on European citizens and investors, as was again exemplified recently in Italy. Therefore, we would advocate for leverage constraints on EU banks, at levels much lower than the current practice. Another pressing issue is the existence of a large and unregulated "shadow-banking" system, comprising among others non-bank lenders, hedge funds, securitization funds, etc… This sector needs to be regulated to reduce the risk in the financial system.

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

We think an EU sustainability taxonomy should cover all assets i.e. bonds, loans, equities, as well as capital markets products such as derivatives. We would like to see three dimensions of "sustainability" addressed in the taxonomy:

- The "Green" Sustainability should in our view cover Co2/GHG emissions (scope 3), impact on biodiversity, intensity of use of natural resources, where indicators are available.
- "Financial" sustainability should also be considered. For instance, a maximum leverage could be considered, not only for banks but also for investment funds. This would create more stability in the financial system and therefore free up capital for long term investment, much necessary to finance the transition, and largely unavailable as of today.
- "Social" sustainability should be included i.e. contribution to the creation of quality jobs, protection of human rights, equal access and equity concerns.

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

We at Finance Watch are of the opinion that sustainable assets should receive a label delivered by the EU after having been granted by the relevant national authorities.

We feel that such labelling process should not be an insulated taxonomy exercise, but should be consistent with the national and EU wide investment plans that the EU should design in order to achieve the Paris Agreement commitments. Following the Intended Nationally Determined Contribution exercises, countries and the EU should establish and implement economic plans that will effectively put the Eurozone on the path to adaptation and mitigation to climate change. This, in our view, covers the most urgent and the essential part of "sustainable investments". We agree that all sustainability issues may not be directly addressed by this, such as for instance the protection of biodiversity, or a number of the SDGs. But we observe that without this, the consequences of climate change may well override any other consideration or action.

We feel that ex post controls of the use of the label should be affected, and the labelling process adapted accordingly. This, combined with a stringent label delivery process, and economic policies enabling green investment opportunities to multiply, should in our view help avoid green washing.

We would also recommend that EU public banks and institutions should lead the way by increasing their sustainability requirements on the assets they finance.

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

We think such a structure should adapt financing to the projects, and not adapt the projects to the financing as seem suggested in some parts of the interim report. Such a structure should design the tenders for EU sustainable projects, which implies establishing how much public funds could be invested and on which terms, as well a setting the tariffs. The balance of risk and rewards in Public Private Partnerships should take care of the general interest. This design should be carried on alongside the EU and national investment plans devised to implement the Paris Agreement as above.

We also think that not all transition projects can be financed using infrastructure financing techniques. According to some estimates, half the required investments for the transition to a 2° economy are in energy efficiency. Many of those are small, local objects which cannot be financed by large infrastructure project financing techniques involving bonds and capital markets. Those projects will be best sourced, implemented and financed by credit from smaller local banks, who have a direct relationship to the customer and are better able to adapt to the evolution of the project over the life of the credit. Therefore,

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we think the EU should promote the development of such a network of local banks in the Eurozone, possibly in association with existing banking networks.

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

Yes.

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

We think that short termism in investment affects corporates and banks (with not enough long-term money in or out). In many sectors of the economy, short termism puts pressure on employees, both via day to day pressures, lay-offs and the "uberization" of employment.

We view short termism as a direct consequence of the deregulation of finance and the economy. This creates uncertainty for the future that pushes investors and valuations towards the short term. In order to give more value to the future, which is a prerequisite if we want to care for nature and the planet, we need to have more certainty. Economic and financial regulation are required to provide more stability in prices over the long term. Again, visibility on the long-term price of carbon (see Stern Stiglitz report as above) is an urgent step in this respect.

Short termism is very much a management orientation coming from shareholders, who are in a hurry for prompt returns. We suggest that the banking sector could be protected from short-termist temptations by putting in place a minimum holding duration for bank shares, such as 5 years.

We also think that certain short term or extremely short-term transactions, such as High Frequency Trading, are increasing the instability of the financial system. We think that a Financial Transactions Tax may be an appropriate instrument to reduce the returns and therefore the attractiveness of such transactions. We would recommend pursuing the reinforced cooperation agenda for the FFT implementation.

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

The EU could give a clear signal that sustainable regulation is underway by creating a transverse task force following the HLEG exercise, involving not only FISMA but also DG ENV, DG Clima and DG Energy to work on implementing the Paris agreement at EU level. The objective of this task force would be to align the EU policy objectives globally with a 2° compatible economy objective. Such an agenda for the EU economic objectives would also aim to be compatible with the SDGs.

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

We think the following actions can unlock a pipeline of sustainable investment projects at EU level:

- Implementing a carbon tax/pricing at the right level, as outlined in the Stern-Stiglitz Commission report: this will make so many projects profitable, unlock a pipeline of green projects.
- Designing and publishing national and EU wide investment plans aligned with the INDC to implement the Paris Agreement.
- Regulating the leverage of the banking and shadow banking systems so that capital shifts to longer, lower return investments.

Question 8. What are some of the most effective ways to encourage credit rating agencies to take into consideration ESG factors and/or long-term risk factors?

Please choose 1 option from the list below

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

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

As per recommendation 4 of the report, financial institutions including banks should disclose their sustainability exposure and policies, including both risks and opportunities, following implementation at wider EU level of Article 173 of the French Energy Transition Law.

This non- financial reporting information would then be available to all, including credit rating agencies. They could therefore incorporate the reported exposure into their rating assessment if they deem it appropriate (that is, if the climate exposure is affecting the credit risk on the considered debt issue). This mandatory climate exposure reporting requirement will increase awareness at company level and also at investor and stakeholder level, hopefully triggering widespread climate risk mitigation action.

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

As suggested in the HLEG interim report, "green" the Basel 3 capital framework to encourage green investment and penalize brown.

More generally we need to encourage banks to direct their activities towards sustainability and activities that are demonstrably useful to society. The deregulation of credit has led to unsustainability, and the banking sector is still in permanent crisis or risk of crisis 10 years after. For instance, banks lend too much to real estate (close to 60% of their lending for seventeen advanced economies).

As per question 4, we think some re-intermediation of credit within the EU would foster sustainability. We feel banks should be encouraged to deploy credit towards long term funding, be it on a corporate or project basis. Banks with suitable long-term lending capacity and a focus on financing the transition towards a 2° C and socially sustainable economy, should be encouraged at EU level.

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

Review the Solvency 2 capital framework, as suggested in the interim report, to alleviate current constraints on long term investment

Launch a EU wide survey of insurers similar to the one carried in the US by the National Insurance Association of Commissioners to evaluate how insurers are prepared to face the physical consequences of climate change. The EU needs an adaptation plan involving not only the national states but also insurers and reinsurers.

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

The EU and national states should carry extensive socio-economic valuations of investment before tendering them to the private sector, taking into account affordability and inequality criteria.
The increased pricing of externalities (such as carbon emission) should go along with the necessary redistribution policies so that they do not contribute to increase inequality or leave vulnerable some parts of the population.

The socio-economic appraisal of projects should prioritize those projects who create long term and quality employment for EU citizens. They should also consider labour individual and collective rights not only for direct workers inside the EU but also for indirect employment like the supply chain outside the EU.

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

The interim report does mention at V p 42 the need for a more effective carbon price signal in the EU mentioning that « firms, investors and civil society have been calling it for years ». It is not mentioned in this survey and as already said is a cornerstone of a sustainable economy in our opinion.

The interim report does not pay enough attention in our opinion to the social objectives of a sustainable development, as per the Sustainable Development Goals: No poverty (SDG 1), Good Health and well-being (SDG 3), Quality Education (SDG 4), Decent Work and Economic Growth (SDG 5), among others. While we are convinced that the transition path to a 2° sustainable economy is fully consistent with meeting those objectives, we would like to see in the final report more information on the policy commitments of the EU to achieve those, within the EU and outside.

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

We feel the monetary policy issue is missing from the report. In many cases, particularly when States are concerned, there is no investment capacity because of excess debt and debt overhang at State level, notably from the 2008 crisis. The financial weakness of States in the EU is in our view a key factor of uncertainty therefore unsustainability. We need a fiscal stimulus for the public sector to be able to support the private sector in moving to sustainability.

We also feel the expert group should cover tax avoidance at the EU level and the existence within the Eurozone or on its immediate borders of low tax countries where capital does not contribute enough to the costs of public services, such as education, health and transport. We therefore recommend including an increased ambition to reduce the tax race competition to the bottom within the EU in the final report, as well as tackling unlawful tax avoidance via the use of tax havens.

We feel the existence of an opaque and largely unregulated "shadow banking sector" (including among others non-banking lenders, hedge funds, securitization vehicles), representing 40% of capital in the EU at the end of 2015, is not compatible with the development of a sustainable financial system or economy. We would like the final report to mention that the shadow banking sector in the EU needs to be supervised and regulated, as a large part of the capital available to finance the transition towards a 2°C and socially sustainable economy rests there.

We congratulate the expert group for an otherwise quite extensive work and are pleased that the dialogue with the Civil Society Organizations is now running on these topics. We hope to have further opportunities to be a public interest voice in the elaboration of EU legislation.

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