Final Report of the High-Level Expert Group (HLEG) on sustainable finance

Some promising progress, but blind spots remain

March 2018

The High-Level Expert Group (HLEG) on sustainable finance has published its final report* on 31st January 2018. In this note Finance Watch highlights its reaction to, and analysis of the report.

First, sustainable finance is multi-dimensional, and therefore an overarching, coordinated EU-wide approach is required to pursue long-term sustainability goals.

Second, it is public authorities’ responsibility to promote policies aimed at correcting market failures. Only public policies that adequately price negative externalities, in particular Co2 emissions, can make sustainable investments profitable on a large scale and therefore trigger the widespread emergence of sustainable assets, without which the financial system cannot be sustainable. Urging policy makers to enforce the adequate pricing of negative externalities and accompanying policies should have been among the top recommendations of the HLEG to EU policy makers.

Third, Finance Watch stresses that many reforms are still required to address financial instability, a key obstacle to long-term investments, and to promote increased diversity of business and governance models in the banking and financial sectors.

With regard to specific recommendations from the group:

1. ESTABLISHING AND MAINTAINING A COMMON SUSTAINABILITY TAXONOMY AT THE EU LEVEL.

The taxonomy would be a very welcome starting point towards more clarity in the market on what a sustainable asset is.

While acknowledging the above it is important to highlight that positive criteria should be complemented by negative criteria which would also enable the identification of non-sustainable assets. The transition will not be achieved by piling up green assets onto a generally brown economy, but by shifting away from a fossil fuel-based economy to a low carbon one.

Moreover, the taxonomy will be all the more useful if it connects to the EU strategy and investment plan for switching to a low carbon economy. Financial markets should be able to recognize the direction of the EU investment plans in their balance sheets, and vice versa. The consistency of the taxonomy with EU investments priorities will also help assess the effectiveness of the policies.

2. CLARIFY INVESTORS’ DUTY TO BETTER EMBRACE LONG-TERM HORIZON AND SUSTAINABILITY PREFERENCES

The consideration of sustainability factors should be part of investors’ legal duties. However, we think that the recommendation could have been more ambitious, by specifying how the proposed interpretation would fit the current industry practices where the best interest is commonly understood as financial return maximization and risk minimisation.

Moreover, any clarification of legal duties should make clear that stewardship of investments is a fundamental part of the legal duties.

Investors should also provide clear information to their clients about the potential risks and benefits of including ESG factors. This is especially important as retail savers express a potentially high appetite for sustainable investment. If sustainable investments are to become popular retail investment products, then there should be full transparency from asset managers and asset owners in order to protect the final investor’s interests.

3. UPGRADE DISCLOSURE RULES TO MAKE SUSTAINABILITY RISKS FULLY TRANSPARENT, STARTING WITH CLIMATE CHANGE

The recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) should be endorsed by the EU and made mandatory.

Taxonomies and methodologies for reporting should be standardised to allow comparisons and aggregations of reported information. This would give regulators and market supervisors a better view on global market trends, and therefore a better capacity to take corrective action if necessary.

4. KEY ELEMENTS OF A RETAIL STRATEGY ON SUSTAINABLE FINANCE: INVESTMENT ADVICE, ECOLABEL AND SRI MINIMUM STANDARDS

Retail investors should be given the possibility to invest in portfolios which reflect their sustainability and ethical preferences, and this can only be achieved if the transparency on sustainability profile of retail funds is improved.

The 4th recommendation would certainly give more clarity to retail investors on what a sustainable investment fund is.

5. DEVELOP AND IMPLEMENT OFFICIAL EUROPEAN SUSTAINABILITY STANDARDS AND LABELS, STARTING WITH GREEN BONDS

The development and implementation of official European sustainability standards and labels would be an important step in fighting greenwashing. The proposed EU Green Bonds Standards recommended by HLEG are stricter than current industry practices and should give more confidence to the investors that the underlying projects of European Green bonds issuance are aligned with the EU Sustainability Taxonomy.
While the HLEG expert group recommends an external review at a minimum upon issuance, it needs to be noted that the external review should be mandatory for the impact monitoring as well as to ensure that the proceeds are used in a way that conforms with the green bond labelling elements presented at issuance.

6. ESTABLISHING SUSTAINABLE INFRASTRUCTURE EUROPE

Sustainable Infrastructure Europe, by providing strategic advice and expertise could significantly contribute to supporting the development of sustainable infrastructure projects, notably in Central and Eastern Europe where there is major infrastructure investment gap. We would like to stress however that many small transition projects cannot be financed by large financial markets infrastructure financing techniques. As mentioned elsewhere in the report, it is important to spur a diversity of financial institutions that finance the transition. Local, long-term lending capacities are missing in certain parts of the EU, they can and should play a significant role in achieving a just and inclusive transition.

7. GOVERNANCE AND LEADERSHIP

The Commission’s ambition to align the corporate culture of financial institutions with sustainability and broader society’s interests is very welcomed.

We recommend that European Supervisory Authorities (ESAs) guidance documents are used to introduce key performance indicators assessing the level to which corporate governance of financial institutions is aligned with sustainability.

8. INCLUDING SUSTAINABILITY IN THE SUPERVISORY MANDATE OF THE ESAS AND EXTEND THE HORIZON OF RISK MONITORING

The mandate of ESAs should be extended to include sustainability and go further from what is included in the Commission’s proposal setting amendments to the ESAs Regulations.

We welcome the HLEG recommendation that ESAs should build expertise on tools for scenario analysis, monitor the mismatch of time horizons and ensure consistent implementation of the single rulebook.

ESAs should also be given a clear mandate to conduct analysis on a European-wide basis of ESG factors. This would include producing a report on ESG factors, to take account of National Competent Authorities’ (NCAs) enforcement of requirements related to ESG included in existing and future EU financial services legislation.

The ESAs should also have the power to issue opinions to identify and propose areas where ESG factors can be better taken in account in EU financial services legislation. These opinions should be submitted to both the EU institutions and the new European Observatory on sustainable finance being proposed by the HLEG on sustainable finance. The ESAs should be able to use its powers to address ESG factors themselves, not just as a consequence of its other tasks.

In any case the scope of the mandate should be aligned with the content of all previous recommendations and the related future legislation to ensure their effective implementation and monitoring.
With regard to other HLEG cross-cutting recommendations and sector specific recommendations:

- We highly support HLEG recommendation that the Commission should **assess the sources of short-termism in the financial system** and identify whether and to which extent the current regulations might contribute to stimulating it.

- **Capital requirements rules for banks should not be softened for green assets**, because this might undermine the resilience of the banks while it is highly questionable whether this measure would actually incentivize green lending. We would recommend the introduction of a penalizing factor for non-sustainable investments, which would at least have the merit of contributing to increase, rather than decrease, bank’s prudential capital.

- The establishment of an **EU Observatory on sustainable finance is necessary** if we are to follow both the development and effectiveness of sustainable finance. Lack of comparable data, in additional to lack of standards for sustainable assets, is one of the key obstacles for the development of the market for sustainable financial products.

- The Commission should investigate whether **alternative accounting approaches to fair value/mark-to-mark valuation for long-term investment portfolios** of equity and equity-type instruments are needed to promote long term sustainable investments.

- The Commission should investigate whether the **implementing measures of Solvency II should be adapted to promote long-term sustainable investments**, which form the most part of the transitions needs towards a low carbon economy.