Initial assessment of the HLEG on Sustainable Finance Interim Report
Joost Mulder – 16 August 2017

On 13 July 2017, the European Commission's High-Level Expert Group on Sustainable Finance. published its interim report. The report is open for consultation until 20 September – responses before 6 September will be considered in the mid-September meeting of the Group.

Context of the report and impact on the Commission's work programme

Overall, the report contains and impressive detailed assessment of the state of play of sustainable financial markets. Most recommendations are to be welcomed, even if they can be further improved.

However, it's uncertain what the impact of the report on the Commission's policy and work programme will be, given that most recommendations rely on voluntary market initiatives, interpretative guidance, and member state action, as well as the limited amount of timing remaining for this Commission to take legislative action.

Another complicating factor is that the HLEG work is presented as part of the Capital Markets Union, one of the three Juncker Commission flagship projects, under leadership of the Commission's Financial Stability DG (DG FISMA). This framing limits its impact on the overall Commission priorities – a good example is the recommendation to check future financial services legislation for compatibility with sustainable finance. Arguably, rather than merely checking future financial stability legislation, the Commission should take political ownership and consider (top-down) how it will promote financing of a transition to a more sustainable European economy. This could include measures outside of financial services that promote sustainable growth and job creation, with DG GROW and DG ENV (for environment issues) in charge.

The HLEG report covers many aspects of society related to sustainable finance, including investment mandates, product transparency, improved ratings, a taxonomy for "sustainable" investment, macro-economic initiatives, supervisory changes and accounting standards. This will attract a lot of diverse responses to the consultation and one has to wonder whether all of these often conflicting ideas can be integrated in a four months remaining in the HLEG's mandate.

Summary of suggested improvements

We would suggest the following improvements to the recommendations in the HLEG Interim Report:
- There should be more ambition on the **scope of transparency and classification** (recommendation 1), moving the scope beyond environment/climate risk and also expanding the scope in terms of which investments are involved
- Instead of subsidizing "green" investments, recommendation 2 and 8 should reflect the need to **correct the negative externalities attached to traditional finance**
- The section on fiduciary duty (recommendation 3) should promote **better and more detailed mandates** and their propagation throughout the investment chain
- Recommendation 4 on disclosure should include **measures to stimulate ESG-impact rating**, either as a stand-alone product or integrated into "financial" ratings
- A sustainability test for future financial legislation as advocated in recommendation 5 should be a starting point; the Commission should be encouraged to **take specific initiatives** aimed at stimulating a transition to a more sustainable economy, and to **integrate ESG/SDG impact into impact assessments**, rather than simply disclosing it.

<u>**Detailed assessment of the individual recommendations**</u>

Recommendation 1 to introduce a classification system for sustainable assets:

- The title is promising but the actual recommendation <u>ignores</u> that there will never be a single definition of "sustainable" investments
- We do not need one definition of sustainability either, but a rating/scoring/analytical <u>framework</u> to allow asset owners to make standardized choices as regards sustainability, or "taxonomy" as the recommendation calls it
- The obvious <u>risk</u> is greenwashing and this needs to be prevented in the course of building up a "common EU classification of sustainable assets", one of the detailed suggestions
- Other DGs beyond DG FSIMA and DG ENV need to be involved, in particular DG GROW. DG FISMA has clearly stated that (only) in environmental/climate "risk" has a "tipping point" been reached; DG ENV cannot be expected to look beyond environmental issues either – this requires high-level political buy-in.

Recommendation 2 to create a European standard and label for green bonds:

- This recommendation is an example of the risk of recommendation 1, by focusing on green bond standards only.
- The suggestion to stimulate green securitisation is a strong hint that this initiative will be purely of a "carrot" nature (incentives, to be phased out using a sunset clause) rather than a "stick" for grey finance. Rather than artificially stimulating green investments by making them “cheaper”, traditional finance should incorporate externalities and compete with green investments on fair terms.
- The report hints that "brown-penalising factors" could/might/may be considered but this is not reflected in the recommendations, perhaps as it is a minority opinion in the HLEG group.

Recommendation 3 on fiduciary duty:

- This is a very good recommendation, although pointing to the need for improved national definitions of fiduciary duty is probably masking the underlying problem of lack of detailed mandates; often fund managers propose and calibrate mandates in line with market supply, which creates a Catch-22 situation (mandates have to be watered down to reflect what’s on the market, and supply doesn’t change as fund managers believe there is no demand)
- Instead, we would suggest introducing measures addressing fragmentation of the investment chain; less intermediaries means a closer coordination between asset owner and asset manager which would make it easier to match market supply and demand. (Interestingly, this is mentioned in the report/executive summary but not in the recommendations)

Recommendation 4 on disclosures for sustainability:

- The (delayed) Non-Financial Reporting Directive review due December(!) 2018 is an opportunity to improve ESG disclosure; however, it’s not realistic to expect any legislative initiative before 2020 due to the change of Parliament and Commission in 2019
- Transparency of (large) corporates does not suffice as a stand-alone measure, and there remains a need for specific independent "ESG" indexes to be developed; in a perfect world with negative externalities integrated in financial ratings, there would be no need for "ESG"-ratings, but in the short-term they can help develop a critical mass of sustainability-rated investments
- The report somewhat recognizes that credit rating agencies can play a role here, but merely integrating TCFD in their financial ratings (see page 39) is not enough

Recommendation 5 on integrating sustainability in financial legislation:

- Not just in DG FISMA, but throughout the Commission, impact assessments should and do endeavour to integrate (not just "describe") externalities in the impact assessment; however common problems known to impact assessment remain (bias towards quantifiable short-term costs on well-defined actors)
- Trade agreements are perhaps not the best template to address sustainability concerns (e.g. TTIP and agriculture in ACP countries)
- "Mitigating ESG risk" as a policy objective is precisely the wrong approach; the policy objective should be to integrate external ESG costs in mainstream financial decision-making
- It makes sense to use the UN SDGs as a test for new policy initiatives (although arguably the SDGs should drive the Commission's policy-making agenda if the Commission is so committed to them)

No specific comments on **Recommendation 6 on "Sustainable Infrastructure Europe"**

Recommendation 7 on the ESAs is helpful, but no substitute to prescriptive "Level 1" rules.

Recommendation 8 on "accounting standards" (sic) for energy efficiency:

- Like recommendation 2, the assumption here is that "green" investment should be stimulated, e.g. by exempting these from the SGP (Maastricht Treaty) rules. Why not penalize "brown" (grey) investment so that green investment can compete on fair terms?