Capital Markets Union Unit

Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Dear Sir/Madam,

Re: Capital Markets Union Mid-Term Review

The Principles for Responsible Investment (PRI) welcomes the opportunity to respond to the European Commission's Capital Markets Union Mid-Term Review, and to share our perspective on one of the key challenges of the 21st century – aligning capital flows with sustainable development.

Overarching view – the need for sustainable financial systems

The financial system is an integral part of modern economies – banking, savings, investment and insurance all play a critical role in supporting and enabling economic growth and development.

The financial system should support sustainable and equitable economic development. In doing so, it should enable everyone to access their income today and save for the future use. It should also provide capital to invest productively, innovate and provide for everyday needs. This important objective is reflected in the EU 2020 commitment to inclusive, sustainable economic growth as well as the objectives of the Capital Markets Union.

The financial system does not function as effectively as it should. It can, and has, failed to respond to the needs of many who use and rely on the system, including beneficiaries and savers. It can undermine sustainable economic development and it can damage the health of the natural environment. It can also create major negative impacts on the global economy, as we have seen through the lack of stability and resilience following the global financial crisis.

The PRI contributed to and fully supports the consultation response submitted by the Sustainable Finance High Level Expert Group (HLEG), to which the PRI is an observer. The group's task is to develop a comprehensive programme of reforms to align European financial markets with sustainable, inclusive economies. We recommend that the Commission view the HLEG's findings as a core component of the Capital Markets Union.

The Commission should also ensure that sustainability remains part of financial policy-making processes beyond the time horizon of the HLEG. We note proposals for a 'sustainability test' for all future legislation. We would also encourage the Commission to consider formal governance to monitor and guide the development of sustainable finance across the EU.

The PRI's *Sustainable Financial System* programme

The PRI believes that investors and policy makers should work together towards a more sustainable financial system. The PRI has conducted an extensive analysis to identify the main areas of reform required to achieve a sustainable financial system. These are:

1. A focus on short-term investment objectives.
2. A lack of attention to beneficiary interests (beneficiaries of pension funds).
3. Improved policy-maker design, implementation and monitoring of policy frameworks that encourage or require long-term responsible investment.
4. Capture of government policy by vested interests.
5. Inconsistent ESG integration in the activities of brokers, rating agencies, advisors and consultants on investment decisions.
6. Principal-agent relationships in the investment chain.
7. Cultures of financialisations and rent-seeking in market actors.
8. Investment incentives misaligned with sustainable economic development.
9. Investor processes, practices, capacities and competencies on ESG integration.

The PRI is undertaking a series of projects to address these issues. We would welcome an opportunity to brief the Commission on these projects.

We look forward to contributing this research to the High Level Expert Group. Below, we identify some short-term proposals which we believe will complement the HLEG's findings. We elaborate further on these in the attached briefing. Our recommendations are set out under the following headings:

- **Embedding ESG in investor obligations and duties**. The EU should issue clarifying guidance on ESG and fiduciary duties as soon as possible, and seek opportunities to amend the definition in primary legislation as EU Directives come up for review.
- **The role of asset owners in driving responsible investment**. The EU should act to ensure consistent, high quality implementation of the IORP II Directive by member states.
- **Advanced stewardship and ownership practices**. The European Commission should accelerate action to promote simple, efficient cross-border voting to support new stewardship duties under the Shareholder Rights Directive.
- **Improving corporate ESG disclosure**. The EU should seek opportunities to align corporate disclosure requirements with the Financial Stability Board's Taskforce on Climate-Related Disclosure.

The PRI remains committed to supporting the EU's ambitious programme on sustainable finance. Please do not hesitate to contact us for further information on any of the issues raised here.

Yours sincerely,

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DETAILED RECOMMENDATIONS

EMBEDDING ESG IN INVESTOR OBLIGATIONS AND DUTIES

The term “fiduciary duty” is not formalised into EU law. However, institutional investors and fund managers have analogous duties:

- Pension funds and insurers in the EU use the guiding “prudent person principle”, which encompasses a duty to act in the best interests of the beneficiary and to act prudently.
- Investment firms are required to adhere to conduct rules. These include a duty to act in the best interests of clients (duty of loyalty) and a duty to act professionally, and with due care and skill (duty of prudence)[1]. These are the core components of fiduciary duty.

In 2015, the PRI and the UNEP Finance Initiative published Fiduciary Duty in the 21st Century which demonstrated that failing to consider long-term value drivers, such as ESG issues, is a failure of fiduciary duty. The report further argues that engagement, voting and public policy work should be undertaken in the best interests of beneficiaries. It recommended that the European Commission should provide guidance to the competent member state authorities on interpretation of fiduciary duties.

The PRI contributed to the DG ENVI Report Resource efficiency and the fiduciary duties of investors, which also recommended the Commission issue clarifying guidance.

Such a guidance would have an analogous effect to the US Department of Labor’s Interpretive Bulletin (IB 2015-01) on Economically Targeted Investments (ETIs) and Investment Strategies that Consider Environmental, Social and Governance (ESG) Factors. This bulletin acknowledged that “environmental, social and governance factors may have a direct relationship to the economic and financial value of an investment, and when they do these factors are proper components of the fiduciary’s analysis”.

In 2016, the PRI, UNEP FI and The Generation Foundation coordinated an investor statement requesting clarification of the law. As of March 2017, the Statement has been signed by over 120 investment firms. It asks for consistent application of the following principles:

> Investors and other actors in the investment system must:
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> - Act with due care, skill and diligence, in line with professional norms and standards of behaviour.
> - Act in good faith in the interests of their beneficiaries and clients, including avoiding conflicts of interest, or where such conflicts are unavoidable, to balance and disclose such conflicts.
> - Take account of environmental, social and governance (ESG) issues, in their investment processes and decision-making, encourage high standards of ESG performance in the companies or other entities in which they are invested, and support the stability and resilience of the financial system.

[1] For example, MiFID article 24 requires a firm to “*act honestly, fairly and professionally and in accordance with the best interests of its clients*”. Equivalent rules are embedded in AIFMD (article 12) and UCITS (article 25).

The PRI recommends that the European Commission:

- **Issue guidance to Member States on consistent interpretation of fiduciary duties and ESG issues, in line with the Investor Statement on Obligations and Duties, now supported by over 120 institutional investors.**
- **Consider further amendments to primary legislation (e.g. Prudent Person Principle as defined in IORP II, conduct rules as defined in MifID II) to align with this statement.**
- **Encourage member states to ensure that responsible investment-related legislation is harmonised and consistent across Europe.**
- **Monitor the implementation and report on the outcomes that result.**

Further details of our fiduciary duty programme can be found at www.fiduciaryduty21.org.

STRENGTHENING THE ROLE OF ASSET OWNERS

Even though many asset owners have made commitments to responsible investment, the majority have yet to ensure that these are effectively implemented. There are inconsistencies in investment practices in different asset classes, high-level statements on sustainability or ESG issues are often missing from investment beliefs, and responsible investment commitments are not embedded in investment mandates.

This creates a multiplier effect throughout the investment market[2]. Weak implementation of responsible investment by individual asset owners sends signals to the investment market as a whole that responsible investment is not a priority for asset owners. In turn, this limits the willingness of investment consultants and investment managers to focus on responsible investment and ESG issues in their products and in their advice.

Within the asset owner community, corporate pension plans remain under-represented among investors that explicitly employ ESG integration techniques. The reluctance of corporate plans to make public commitments to responsible investment is reflected in PRI's signatory base.

By implementing their commitments to responsible investment with sufficient scale and depth, asset owners can accelerate the development of responsible investment through the investment chain.

The recently revised Institutions for Occupational Retirement Provision (IORP II) Directive requires pension funds to establish an "own risk assessment", which should include material ESG factors. The system of governance should also give consideration to ESG issues. This clause is designed to ensure beneficiaries' savings are invested with a view to mitigating emerging ESG risks, such as stranded assets. While some competent member state authorities have conducted thorough analysis of climate risk[3], awareness and practice varies considerably across member states.

The PRI recommends that the EU:

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[2] For further analysis, see How asset owners can drive responsible investment: beliefs, strategies, mandates, PRI, 2016.

[3] For example, the Dutch Central Bank's analysis of climate risk within the pension system.

- **Publish additional guidance to IORPs and competent member state authorities to ensure high quality, harmonised implementation across member states.**
- **The guidance should address pressures experienced by many corporate pension plans, including deficit management, risk transfer and resource constraints.**

The advice given by investment consultants, is often seen as not supporting proactive approaches to responsible investment. Investment consultants often base their advice on a very narrow interpretation of investment objectives. While the major consulting firms now have responsible investment specialists or small teams focused on responsible investment, these are usually established as separate advisory centres rather than being integrated into all investment advisory services, which results in ESG being an additional service and cost.

The PRI is undertaking an asset consulting services review. The project aims to ensure asset allocation advice by investment consultants is consistent with a sustainable financial system.

ENGAGEMENT AND VOTING

The PRI welcomes the new requirements relating to engagement, voting and long-termism within the revised Shareholder Rights Directive. Encouraging greater stewardship around long-term value creation is strongly aligned with the six Principles and the PRI's mission.

We also welcome additional work within the SRD to facilitate cross-border voting transmission. The additional duties placed on investors must be supported by substantial improvements to ensure voting is cost-effective and practical.

The PRI recommends that the European Commission prioritise action to encourage simpler, more reliable cross-border voting transmission.

CORPORATE DISCLOSURE

The Commission's consultation on *long term, sustainable investment* concluded that many investors continue to struggle with access to adequate ESG data. In particular, data provided in corporate disclosures is often backward-looking, difficult to compare and fails to provide insight into how the company's business model is prepared to respond to ESG trends.

The PRI believes ESG factors should be disclosed in the same wrapper as the annual report and the other outputs of conventional accounting practice, with clear links between ESG factors and the company's business model and risk factors. ESG factors should over time be subject to the same levels of assurance as financial data. We suggest a phased introduction which reflects the development of the reporting frameworks for ESG factors. Companies should report using common performance metrics to allow for comparability, in particular, comparability by industry, portfolio and across time-series; codifying industry and sector-specific key performance indicators for ESG factors. Companies should disclose additional company-specific ESG risks and opportunities

The Financial Stability Taskforce on Climate-Related Disclosure provides the best opportunity to implement a consistent, forward-looking and harmonised disclosure regime.

The PRI recommends that the European Commission:

- **Implement these guidelines into the non-binding guidelines under the Non-Financial Reporting Directive, and identify opportunities to align primary legislation.**