Principles for Responsible Investment

# THE EUROPEAN COMMISSION ACTION PLAN

## FINANCING SUSTAINABLE GROWTH

## ASSESSMENT OF THE REFORM AREAS FOR PRI SIGNATORIES

*Version 2, published in July 2018, incorporates the European Commission's regulatory proposals on Action Plan areas 1 (taxonomy), 4 (investment advice), 5 (sustainability benchmarks) and 7 (investor duties).*

FINANCE UNEP INITIATIVE
United Nations Global Compact
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

# THE SIX PRINCIPLES

## PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

## PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.


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# INTRODUCTION

On 7 March 2018, the European Commission released an action plan for financing sustainable growth. The plan is a response to recommendations from the High-Level Expert Group (HLEG) on Sustainable Finance, which were submitted to the Commission on 31 January 2018. Nine PRI signatories were members of the HLEG. The PRI served as an Observer, providing technical input on many of the recommendations.

The PRI issued an initial assessment of the 10 reform areas in the action plan. The Commission has committed to a timeline for implementation of the reforms, with the first legislative proposals published in May 2018.

In this second version, we update the assessment to include the first legislative measures proposed by the Commission to implement four of the actions set out in the action plan, namely taxonomy, investment advice, sustainability benchmarks and investor duties.

Speaking at a PRI event held in Brussels in June 2018, European Commission Vice-President Valdis Dombrovskis introduced the first four actions proposed by the Commission. These actions are interconnected and relevant for all investors.

Working towards a sustainable financial system is consistent with the PRI's Blueprint and Mission. The PRI welcomes the action plan and will continue to work with signatories and the European Commission to support its delivery through the accompanying legislative measures.

For more information on the action plan and the PRI's sustainable financial system and policy activities, email policy@unpri.org.

## THE ACTION PLAN OUTLINES TEN REFORMS IN THREE AREAS:

The four legislative proposals adopted in May 2018 address **several areas** of the Action Plan.

### REORIENT CAPITAL FLOWS TOWARDS SUSTAINABLE INVESTMENT, IN ORDER TO ACHIEVE SUSTAINABLE AND INCLUSIVE GROWTH

1. **Establishing an EU classification system for sustainability activities**
2. Creating standards and labels for green financial products
3. Fostering investment in sustainable projects
4. **Incorporating sustainability when providing investment advice**
5. **Developing sustainability benchmarks**

### MAINSTREAMING SUSTAINABILITY INTO RISK MANAGEMENT

6. Better integrating sustainability in ratings and research
7. **Clarifying institutional investors and asset managers' duties**
8. Incorporating sustainability in prudential requirements

### FOSTER TRANSPARENCY AND LONG-TERMISM IN FINANCIAL AND ECONOMIC ACTIVITY

9. **Strengthening sustainability disclosure and accounting rule-making**
10. Fostering sustainable corporate governance and attenuating short-termism in capital markets

In the following pages, we explain the actions and the possible impact for investors.

## THE FOUR LEGISLATIVE PROPOSALS – AN OVERVIEW

In May 2018, the Commission adopted a package of measures implementing several key actions announced in its action plan on sustainable finance. The package includes:

1. **Taxonomy**
   A proposal for a regulation to establish a framework to facilitate sustainable investment[1]. The proposed regulation establishes the conditions and the framework to create, over time, a unified classification system (or taxonomy) on what can be considered environmentally sustainable economic activities. This is widely seen as a first and essential enabling step in the overall effort to channel investments into sustainable activities.

2. **Disclosure and duties**
   A proposal for a regulation on disclosures relating to sustainable investment and sustainability risks, amending Directive (EU) 2016/2341(IORP 2 - Pensions)[2]. This regulation will introduce obligations on institutional investors and asset managers to disclose how they integrate ESG factors in their risk processes. Requirements to integrate ESG factors in investment decision-making processes, as part of their duties towards investors and beneficiaries, will be further specified through delegated acts.

3. **Benchmarks**
   A proposal for a regulation amending the benchmark regulation[3]. The proposed amendment will create a new category of benchmarks, comprising low-carbon and positive carbon impact benchmarks, to help investors better understand the relative carbon impact of their investments.

4. **Sustainability Preferences (consultation)**
   In addition, the Commission has solicited feedback on amendments to delegated acts under the Markets in Financial Instruments Directive (MiFID II)[4] and the Insurance Distribution Directive[5] to include ESG considerations into the advice that investment firms and insurance distributors offer to their clients.

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1 https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-353_en
2 https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-354_en
3 https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-355_en
4 https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2681500_en
5 https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2681527_en

## ACTION 1:

# SUSTAINABILITY TAXONOMY

## KEY POINTS

- The European Commission has published a proposal for a regulation to develop a sustainability taxonomy. The taxonomy is intended to provide clarity on which economic activities can be classified as environmentally sustainable, and it will be integrated into legislation as it is developed.
- The taxonomy will be the cornerstone of the Commission's other activities to advance sustainable finance, in time providing a yardstick for measuring sustainable capital flows. It will cover activities contributing to climate mitigation and adaptation, adding other environmental and social objectives[6]. The priority is to assess, sector by sector (sequentially), which economic activities within a given sector are good for the climate and the environment.
- A technical expert group[7] (see Annex 1) has been established and will advise on how to develop the criteria for these environmentally sustainable activities. It willl help develop a first taxonomy for the first quarter of 2019, with a focus on climate mitigation activities. By mid-2019, the taxonomy will be expanded to climate adaptation and other environmental activities.
- In addition, a Platform on Sustainable Finance will be created in 2019. It will advise the European Commission on the further development of the taxonomy, including a social sustainability taxonomy in a later phase (after 2021), and on the taxonomy's impact. Bringing together experts from both the public and private sectors, this platform will replace the technical expert group.
- The taxonomy aims to build on existing approaches and taxonomies, including that of the Climate Bonds Initiative, and to evolve dynamically, rather than be set in stone. It will include guidance on sectors, activities, screening criteria and metrics. The system to create and revise the taxonomy is being designed to be responsive to scientific developments and technological change.

## COMMENT

On a practical basis, the sustainability taxonomy should bring much-needed consistency and harmonisation in green and sustainability definitions. PRI signatories around the world have raised concerns about greenwashing and lack of consistency as significant barriers to scaling-up sustainable finance. In its impact analysis, the Commission took the view that clarity is needed on the conditions that economic activities need to fulfil in order to qualify as positively contributing towards sustainability as, at present, a coherent and uniform classification system does not exist at the EU level[8].

It warns that: "The parallel development of market-based and national practices is likely to give rise to divergent classifications, also because these kinds of initiatives are pursuing a specific national policy agenda, are targeting only particular topics, or are based on commercially-driven priorities."

The sustainability taxonomy will, in time, become embedded in EU legislation, providing an important reference point for PRI signatories throughout the EU. The PRI anticipates that policy makers in markets outside of the EU will observe the EU's sustainability taxonomy to inform evolution of their own taxonomies. At the same time, the taxonomy must be flexible enough to change over time, as science evolves and new technology is developed.

European PRI signatories are encouraged to engage actively with the development of the taxonomy in 2018 and to evolve their own sustainability criteria in harmony with those of the EU.

6 The Commission's impact analysis states that "knowledge on how social objectives could be integrated in a taxonomy is not sufficiently developed at this stage for the Commission to commit to develop a detailed taxonomy in that area. Social is also arguably the politically most contentious area of sustainability." Only after an evaluation is made by December 2021 will an extension to a social taxonomy be envisaged.

7 https://ec.europa.eu/info/publications/180613-sustainable-finance-teg-members_en 13 June 2018

8 https://ec.europa.eu/info/law/better-regulation/initiative/238025/attachment/090166e5baea4e21_en Brussels, 24.5.2018 SWD(2018) 264 final COMMISSION STAFF WORKING DOCUMENT IMPACT ASSESSMENT

This taxonomy would have several uses, including:

- Acting as a guidebook for national labelling schemes for green financial products;
- Serving as a reference point for financial market participants to develop green financial products;
- Forming the basis for future EU standards and labels for green financial products, such as green bonds or investment funds. This would guide retail investors towards credible green financial products and give these products increased visibility; and
- Laying the foundations for a single EU market for sustainable investment.

The taxonomy should be a complement to efforts to identify investments that are consistent with the Sustainable Development Goals (SDGs) – noting that it is focused on industrial activities that might contribute to achieving the SDGs.

The initiatives on taxonomy and disclosures (Actions 7 and Action 9.4) are linked. Once the criteria are developed, financial market participants offering environmentally sustainable financial products or services shall disclose how and to what extent they are used to determine the environmental sustainability of the investments selected for the financial product.

## TIMETABLE

- The first delegated act covering the climate change adaptation and mitigation objectives could be adopted by the end of 2019, and the second and third delegated acts, covering the other environmental objectives (pollution and waste prevention, healthy eco-systems and water protection) by mid-2021 and mid-2022 respectively. One reason given for the emphasis on climate change over social factors is that the former has stronger scientific underpinnings, and consensus is much more likely to be reached.
- The European Parliament and Council will need to agree on the proposal.

## ACTION 2:

# STANDARDS AND LABELS

### KEY POINTS

- The European Commission will develop standards and labels for sustainable finance products, including green bonds. The EU Ecolabel Regulation could be used to create an EU-wide labelling scheme and the Commission is considering SRI fund labelling.
- Standards and labels will protect integrity and trust in sustainable finance products, while better enabling investors to access such products, particularly benefitting retail investors.
- The Commission will explore the use of the EU Ecolabel Regulation when the sustainable finance taxonomy is more developed.
- The European Commission will commission a technical expert group to report on an EU green bond standard by mid 2019. By that date, green bond prospectuses must include additional information, under the framework of the Prospectus Regulation.

### COMMENT

Standards and labels will help build confidence in sustainable finance products, potentially increasing institutional and retail investor interest in such products.

The green bond market is small but growing. The EU green bond standard will help it mature and further improve the credibility of green bonds.

PRI signatories should engage with the Commission's plan for standards and labels to ensure these give clients visibility on strong sustainability practices and build trust.
The standards and labels are expected to refer to the sustainability characteristics of the financial products themselves, in relation to the sustainability taxonomy. They are not expected to start with the SDG framework as a categorisation tool for classes of investment, although others may undertake the work to link the financial products to specific SDGs.

ACTION 3:

# FOSTERING INVESTMENT IN SUSTAINABLE PROJECTS

## KEY POINTS

- The European Commission will take measures to improve the efficiency and impact of instruments aimed at sustainable investment in the EU.
- These will build on existing EU initiatives to mobilise investment in sustainable infrastructure, including the Investment Plan for Europe. Mobilising capital for infrastructure is a prerequisite for the transition to a low-carbon economy.
- The European Fund for Strategic Investments (EFSI) has been instrumental in crowding in private finance for sustainable infrastructure, mobilising €265 billion.
- The EFSI has been extended to 2020 and will have a greater focus on green infrastructure, with 40% of its capital directed to sustainable infrastructure and climate action projects.
- The EU External Investment Plan will leverage more than €40 billion of investments by 2020 in partner countries, initially in Africa and the EU's southern and eastern neighbours.
- For the post-2020 period, the European Commission may establish a single investment fund integrating all EU market-based instruments, including those providing technical assistance.

## COMMENT

Increasing the efficiency and impact of instruments for sustainable investment could help attract significant volumes of capital to sustainable infrastructure.
A single investment fund could support investment priorities and simplify interactions between investors, beneficiaries, the European Commission, the European Investment Bank and commercial banks.

Activities to support project development will include technical and project development assistance, which will likely increase the size of the project pipeline and the number of suitable investments.

We note that increasing the capacity of national and local government to deliver investable projects remains essential. Policy stability and related governance frameworks are also essential to attract available capital towards sustainable assets.

The EU already provides significant de-risking and co-investment vehicles to encourage private investment in sustainable assets. This plan should see these vehicles extended.

## ACTION 4:

# INCORPORATING SUSTAINABILITY WHEN PROVIDING FINANCIAL ADVICE

### KEY POINTS

- The European Commission is seeking to amend the MiFID II and Insurance Distribution Directive (IDD) delegated acts to ensure that sustainability preferences are taken into account in the suitability assessments undertaken by regulated entities.
- The European Commission issued a public consultation because it wants to ensure that investment firms and insurance product distributors ask clients about their ESG preferences as well as offer investment advice that includes ESG considerations or objectives. The consultation is now closed.
- Requirements will be specified through delegated acts to be adopted during 2019.

## COMMENT

At present, MiFID II and the IDD require investment firms and insurance distributors to offer "suitable" products to meet their clients' needs when offering advice, but do not contain specific requirements to ask questions regarding clients' preferences concerning ESG issues. This leads to lower observable demand and reduced supply of ESG products: investment advisers have fewer incentives to respond to these considerations, and asset managers have little incentive to design suitable products.

In its final report, the HLEG recommends that investment advisers be required "to ask about, and then respond to, retail investors' preferences about the sustainable impact of their investments, as a routine component of financial advice"[9]. The Commission has acknowledged that uncertainty could be reduced if a revision of MiFID II's delegated act explicitly incorporated investor preferences concerning ESG and sustainability into the suitability requirements associated with financial advice.

The proposed delegated Regulation will – if agreed – require investment advisors to ask about retail investors' preferences regarding ESG, environmentally sustainable investments, social investments and good governance investment. It defines those terms as follows:

- 'ESG preferences' means a client's or potential client's preferences for environmentally sustainable investments, social investments or good governance investments;
- 'ESG considerations' means a consideration related to environmentally sustainable investments, social investments or good governance investments';
- 'Environmentally sustainable investment' means an investment in an economic activity that contributes to an environmental objective, and in particular an environmentally sustainable investment as defined in Article 2 of [insert reference to taxonomy Regulation when adopted]
- 'Social investment' means an investment in an economic activity that contributes substantially to a social objective and, in particular, to tackling inequality, fostering social cohesion, social integration or labour relations, or an investment in human capital or economically or socially disadvantaged communities; and
- 'Good governance investment' means an investment in companies following good governance practices and, in particular, companies with sound management structures, employee relations, remuneration of relevant staff and tax compliance.

This potentially offers a major step forward in integrating ESG issues in investment activity given the broad scope and importance of MIFID across the EU investment regulatory landscape.

While the emphasis in the action plan is on the retail sector, it is important to note that amendments to MiFID II are expected to apply to the work of investment consultants with their institutional clients.

9 https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

## ACTION 5:

# DEVELOPING SUSTAINABILITY BENCHMARKS

### KEY POINTS

- The Commission has published a proposed regulation to amend the existing framework of the benchmark regulation[10] to promote the transparency of benchmark methodologies and features. The intent is to allow users to better assess the quality of sustainability and ESG benchmarks.
- In addition, the Commission proposes the creation of two new benchmarks that should reflect companies' carbon footprint and give investors greater information on an investment portfolio's carbon footprint.
- The low-carbon benchmark would be based on a standard 'decarbonising' benchmark. The underlying stocks would be selected based on their carbon emissions relative to the component stocks in a standard benchmark.
- A more "ambitious" positive-carbon impact benchmark would comprise stocks that are judged to be aligned with the Paris Agreement objective of limiting global warming to below 2°C.
- The purpose of the regulation is to prevent green-washing by providing investors with better information on companies' carbon footprints and CO2 reductions. In addition, it will ensure that comparable information is available on ESG factors, that are related to assets in which the index invests.
- The Commission's technical expert group will, following a stakeholder consultation, publish a report on the design and methodology of low-carbon benchmarks by mid-2019.

## COMMENT

Benchmarks play an important role in the investment landscape. They can be used to create new investment products, to determine asset allocation strategies and to measure performance. The European Commission is seeking to make benchmarks a reliable tool for investors who want to invest in low-carbon strategies. They will do this by establishing a new category of benchmarks, which itself includes two distinct types of benchmarks.

1. **Low-carbon benchmark.**
   This is based on decarbonising a standard benchmark, for example an equity index. The underlying stocks would be selected based on their emissions compared to the stocks on a standard benchmark.

2. **Positive carbon impact benchmark.**
   This should be aligned with the objective in the Paris Agreement of keeping global warming to less than 2°C above pre-industrial levels. The underlying stocks are selected on account of having carbon savings that exceed the stocks' residual carbon footprint.

The European Commission will establish minimum standards for the methodology of these benchmarks in a Commission delegated act.

It is important to note that the proposed regulation will strengthen the explanations to be provided about how ESG factors are reflected in benchmarks that claim to pursue or take into account ESG objectives. The Commission is empowered to further specify the information to be given, following the work of the Technical expert group.

The initiatives on investors' duties (Action 7) and benchmarks and disclosure (Actions 5 and 9) are linked: where asset managers and institutional investors market products as pursuing a low-carbon objective, they would be required to designate an appropriate benchmark, such as the EU low-carbon index or the positive carbon impact index, as a reference. Where no index reflecting the asset managers' low-carbon strategy is available on the market, the asset managers would need to provide a detailed explanation of how they intend to ensure continued adherence to the low-carbon objective.

10 See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32016R1011

## ACTION 6:

# BETTER INTEGRATING SUSTAINABILITY IN RATINGS AND MARKET RESEARCH

### KEY POINTS

- Starting in the second quarter of 2018, the Commission will engage with stakeholders to explore the merits of amending the Credit Rating Agency Regulation to mandate credit rating agencies to explicitly integrate sustainability factors into their assessments. This should be pursued in a proportionate way, to preserve market access for smaller players. Commission services will report on the progress made on this by the third quarter of 2019.
- The Commission invites ESMA to: (i) assess current practices in the credit rating market by mid-2019, analysing the extent to which ESG considerations are taken into account; (ii) include environmental and social sustainability information in its guidelines on disclosure for credit rating agencies by the same point, and consider additional guidelines or measures, where necessary.
- The Commission will carry out a comprehensive study on sustainability ratings and research by mid-2019. It will analyse methodologies and explore aspects such as the market structure of sustainability ratings and market research services, the depth and breadth of sustainability research assessments and scoring, and the independence of those research/scoring providers. The study will also explore measures to encourage sustainability ratings and market research.

## COMMENT

The focus of the European Commission's action plan on sustainability and credit ratings is testament to the role that these instruments play in improving sustainability-risk-adjusted capital allocation. The Commission is taking a prudent approach, calling for more time to conduct research, monitor developments and gather evidence before making concrete policy and regulatory changes. This will allow broader engagement with stakeholders and give greater recognition to important ongoing developments.

The action plan has retained the HLEG's distinction between the two main categories of rating providers: credit rating agencies and sustainability ratings providers. The action plan also mentions market research, which both can provide. The Commission's overall assessment of these market agents gives equal consideration to credit ratings and sustainability ratings.

All planned deliverables listed above are due by the second quarter of 2019 at the earliest. This effectively defers action to the new Commission, to be appointed after the 2019 spring EU parliamentary election.

In the meantime, progress by credit ratings agencies on sustainability issues is likely to continue in the coming months. This will probably be driven by market interest, as fixed income investors join equity investors in starting to incorporate ESG considerations in portfolio allocation. It is the PRI's intention to continue to promote dialogue between investors and both credit ratings agencies and sustainability ratings providers, on how to make ESG considerations more transparent systematic and financially relevant.

## ACTION 7:

# CLARIFYING INSTITUTIONAL INVESTORS' AND ASSET MANAGERS' DUTIES

### KEY POINTS

- The Commission has published a proposal for a regulation on disclosures relating to sustainable investments and sustainability risks, amending Directive (EU) 2016/2341 (IORP 2 - Pensions)11.
- The regulation, followed by delegated acts containing more precise obligations, will clarify that institutional investors and asset managers must integrate ESG factors into their decision-making processes. Institutional investors and asset managers will also have to show how their investments relate to their ESG targets and explain how they comply with these.
- The Commission is proposing a harmonised EU approach to the integration of ESG risks and opportunities in the procedures of institutional investors, asset managers, insurance distributors and investment advisors, as part of their duty to act in the best interest of clients. It would also set uniform rules on how those financial market participants should disclose to investors regarding compliance with the integration of ESG risks and opportunities.
- These investors will have to describe how they integrate sustainability risks, what impact sustainability risks might have on the return of the investment or financial product, and whether their remuneration policy is consistent with integrating sustainability risks.
- To incorporate the disclosure obligation, the European Commission proposal requires the amendment of various pieces of EU legislation that regulate different types of institutional investors and asset managers, e.g. insurance companies (Solvency II) and hedge funds (AIFMD), and those who issue investment products.

## COMMENT

Action on investor duties was recommended by the HLEG, with the Commission already having consulted on the subject in 2017. Clarifying investor duties is a major priority for the PRI as part of our Fiduciary Duty in the 21st Century project with UNEP FI and The Generation Foundation[12].

The proposal includes asset managers and institutional investors – that is, anyone that manages investments on behalf of others. Institutional investors already have a duty to act in the best interest of their clients, and this duty is incorporated into various pieces of EU legislation.
The Commission notes that, for many market participants, sustainability risks are not systematically integrated into their decision-making processes. This is why the Commission is proposing to clarify through delegated acts that this is indeed part of their fiduciary duty. The details will be clarified in upcoming level 2 legislation[13].

In addition, the Commission wants to increase transparency regarding how managers comply with this duty. It believes that there is still a lack of disclosure that means end-investors do not have the information they need regarding sustainability. To remedy this, the Commission has proposed that institutional investors should disclose how they take sustainability risks into account, and what impact those risks may have on returns.

For investment products that actively pursue sustainable objectives, the way these objectives are incorporated into investment decisions would also need to be disclosed. The information disclosure and reporting requirements would be more stringent for those financial products that claim to be sustainable investments than for conventional products.

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11 https://eur-lex.europa.eu/legal-content/FR/TXT/?uri=CELEX%3A32016L2341

12 In January 2016, the PRI, UNEP FI and The Generation Foundation launched a three-year project to address longstanding concerns that fiduciary duty poses a barrier to the integration of ESG issues in investment practice and decision-making. This follows the publication in September 2015 of *Fiduciary Duty in the 21st Century* by the PRI, UNEP FI, the UNEP Inquiry and UN Global Compact. That report concluded that: "Failing to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty." It also acknowledged that, despite significant progress, many investors have yet to fully integrate ESG issues into their investment decision-making processes.

13 "At level 2 the Commission can adopt, adapt and update technical implementing measures with the help of consultative bodies composed mainly of EU countries representatives. This allows the Council and Parliament to focus on the key political decisions, while technical implementing details can be worked out afterwards by the Commission." More information is available here.

Sufficient information is to be given for each financial product beforehand, and up-to-date information needs to be available online concerning the sustainability targets used and the methods applied to measure the sustainability impact.
A periodic report would also need to be published for each investment product on its sustainable impact. The details of these sustainability disclosure requirements will have to be worked out through delegated acts, i.e. through Regulatory Technical Standards (RTS)[14], that will need to be applied and supervised.

An important subsection of this proposal concerns pensions and the IORP 2 Directive. This has been a major area of interest to the PRI, which has supported moves to ensure that ESG concerns are explicitly recognised in the directive (setting a precedent for additional work on the Pan-European Pension Product, or PEPP). However, there has been a lack of coherence in the interpretation of the extent to which ESG factors are required in the duties owed by investors to their beneficiaries. IORP 2 explicitly states only that occupational pension funds should consider ESG factors in their investment decisions, governance and risk management systems. Further analysis indicates that this has not gone far enough and the proposed regulation also introduces a delegated act by which the European Commission will strengthen the requirements to IORPs to integrate ESG risks and factors into their investment decision-making and risk management processes as a way to implement the "prudent person" rule.

The initiatives on investors' duties and disclosure are linked: investors' duties would make it mandatory for asset managers and institutional investors to integrate ESG factors in their investment decision processes, and disclosure requirements would make it mandatory to disclose how this is done.

The initiatives on taxonomy and disclosures are also linked: financial market participants labelling financial products/ services as environmentally sustainable shall disclose how and to what extent the criteria developed in the taxonomy to define environmentally sustainable economic activities are used to determine the environmental sustainability of the investments selected for the financial product.

14 RTS ESMA has the power to develop draft such standards. A specific legislative focus has been put on the technical nature of RTS, with the attached constraint that the underlying assessments brought by the Authority shall not imply "strategic decisions or policy choices". However, drawing the line between purely technical standards and those involving policy choices is not always clear-cut, and some standards that may appear technical in nature may in practice have more far-reaching consequences. This delegated process therefore bears continued scrutiny.

ACTION 8:

# INCORPORATING SUSTAINABILITY IN PRUDENTIAL REQUIREMENTS

## KEY POINTS

- The Commission will explore the feasibility of the inclusion of risks associated with climate and other environmental factors in institutions' risk management policies, and the potential calibration of capital requirements of banks as part of the Capital Requirements Regulation and Directive.
- The aim would be to take into account such factors, where this is justified from a risk perspective, to safeguard the coherence and effectiveness of the prudential framework and financial stability. Any recalibration of capital requirements, based on data and the assessment of the prudential risk of banks' exposures, would need to rely on and be coherent with the future EU taxonomy on sustainable activities.
- In the third quarter of 2018, the Commission will invite the European Insurance and Occupational Pensions Authority (EIOPA) to provide an opinion on the impact of prudential rules for insurance companies on sustainable investments, with a particular focus on climate change mitigation. The Commission will take this opinion into account in the report to be submitted to the European Parliament and Council by 1 January 2021 under the Solvency II Directive.

## COMMENT

Current EU prudential frameworks do not discriminate between green and brown investments. The thinking behind any potential change in prudential rules is based on the assumption that ignoring risks associated with climate change and other sustainability factors can create longer-term risks for financial stability and costs for banks and insurers whose assets are exposed to such risks.

However, any changes to prudential rules will be some way off. A precursor to any recalibration of bank capital requirements is the EU taxonomy on sustainable activities (due to be published in the second quarter of 2019). The Commission will also need to explore the feasibility of including risks associated with climate and other environmental factors in institutions' risk management policies, and the potential calibration of capital requirements of banks, and balance these with ensuring that financial stability is safeguarded (under discussion in 2018-2019).

Similarly, EIOPA will begin the process of forming its opinion on the impact of prudential rules for insurance companies on sustainable investment from mid 2018. The Commission will then report to the European Parliament and Council by 1 January 2021 as part of the process of updating the Solvency II Directive.

This part of the action plan has a substantial way to go. Changes to prudential rules, in combination with the taxonomy, would incentivise banks and insurers to shift their long-term investments into sustainable assets, but modifying prudential requirements on the basis of only one dimension of financial risk may create financial risk in the system. More work is needed.

## ACTION 9:

# STRENGTHENING SUSTAINABILITY DISCLOSURE AND ACCOUNTING RULE MAKING

### THIS ACTION IS LINKED TO LEGISLATIVE INTERVENTION UNDER ACTION 7

## KEY POINTS

- The Commission is launching a fitness check of EU legislation on public corporate reporting, including the Non-Financial and Diversity Information (NFI) Directive[15], to assess whether public reporting requirements for listed and non-listed companies are fit for purpose. It will include the evaluation of sustainability reporting requirements and the prospects for digitalised reporting.
- The Commission launched a public consultation on this in early 2018. The conclusions of the fitness check will be published by the second quarter of 2019 and will inform any future legislative proposals to be adopted by the Commission. The Commission's legislative proposal on clarifying institutional investors and asset managers' duties (Action 7), has now been published.
- This impacts Action 9.4, where asset managers and institutional investors would be requested to disclose how they consider sustainability factors in their strategy and investment decision-making process, in particular regarding their exposures to climate change-related risks.

## COMMENT

In the EU, listed companies are already required to disclose information that investors need to assess sustainability risks. The Commission has published (non-binding) guidelines to help companies disclose this information in a consistent and comparable manner through the Non-Financial Reporting Directive[16].

The first legislative package does not affect financial reporting. However, the European Commission aims to establish a framework that can be used to judge whether the public reporting obligations, including financial and non-financial reporting requirements for EU companies, meet their objectives. This was the aim of the EU Fitness Check on the EU Framework for Public Reporting by Companies[17], which was open for comment until 21 July 2018.

The proposals in Action 9 are non-legislative, apart from the links to the proposal on requiring asset managers and institutional investors to disclose how they use ESG factors in Action 7.

15 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095

16 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52017XC0705%2801%29

17 https://ec.europa.eu/info/sites/info/files/2018-companies-public-reporting-consultation-document_en.pdf

## ACTION 10:

# FOSTERING SUSTAINABLE CORPORATE GOVERNANCE AND ATTENUATING SHORT-TERMISM IN CAPITAL MARKETS

### KEY POINTS

- To promote corporate governance that is more conducive to sustainable investments, the Commission will carry out by mid-2019 analytical and consultative work with relevant stakeholders to assess: (i) the possible need to require corporate boards to develop and disclose a sustainability strategy, including appropriate due diligence throughout the supply chain, and measurable sustainability targets; and (ii) the possible need to clarify the rules according to which directors are expected to act in the company's long-term interest.
- The Commission invites the European Supervisory Agencies (ESAs) to collect evidence of undue short-term pressure from capital markets on corporations and consider, if necessary, further steps based on such evidence by early 2019. More specifically, the Commission invites ESMA to collect information on undue short-termism in capital markets, including: (i) portfolio turnover and equity holding periods by asset managers; (ii) whether practices in capital markets generate undue short-term pressure in the real economy.

## COMMENT

This action is non-legislative and is reflective of the HLEG concerns regarding corporate culture in the financial sector and the need for it to be better aligned with long-term considerations. Norms and values need to deliver on the promise of a sustainable financial system that benefits society.

For investor stewardship to be effective, it is essential that the consideration of sustainability risks and opportunities becomes an integral part of the way in which the investee companies are governed. Hence, the HLEG proposed that a clear commitment to sustainability is embedded in the duties of company directors and into the governance rules related to company management, supervision and incentive structures. The HLEG final report outlines a list of potential actions – "rather than designing a fully-fledged European corporate governance code " – including updating the "fit and proper" tests to include an assessment of the individual and collective ability of the members of governing bodies in financial institutions to address sustainability risks.

There is no mention in the action plan of the expert group on technical aspects of corporate governance, established by DG Justice in 2017[9]. That group provides technical advice to the Commission on technical aspects of listed company corporate governance, including on the use of modern information and communication technologies in corporate governance.

If they do not already, investors should incorporate the corporate governance recommendations in their active ownership practices. Most investors will already monitor portfolio turnover and holding periods. Investors might also want to consider how they incentivise investment decision-making consistent with the investment time-horizons of their clients.

# FINAL REMARKS

The PRI congratulates the European Commission for coming forward with regulatory proposals in such a short space of time. The proposals are broadly in line with those called for by the HLEG, as well as those found in the European Parliament ECON Report on Sustainable Finance[18].

The regulatory proposals will now work their way through the European Parliament and the Council. PRI signatories should note the European Parliament elections in May 2019 and the establishment of a new Commission in late 2019. Given the European Parliament's upcoming summer recess and the election calendar next year, the proposed timetable is challenging.

Nevertheless, there is still opportunity for institutional investors to comment on the various legislative proposals. To receive regular updates on the PRI's European policy work, please email policy@unpri.org. Policy professionals at PRI signatories are also invited to join the PRI's Global Policy Reference Group, which provides a forum for information sharing on global policy initiatives relating to responsible investment.

The PRI hosted an event in Brussels with European Commission Vice-President Dombrovskis on the legislative proposals on 26 June 2018. For details or a transcript, please email policy@unpri.org.

18 http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bREPORT%2bA8-2018-0164%2b0%2bDOC%2bPDF%2bV0%2f%2fEN
MEPs from the Economic and Monetary Affairs Committee have backed a resolution to further harmonise EU capital markets with long-term sustainable objectives. The report was adopted in April 2018.

# ANNEX 1

## TECHNICAL EXPERT GROUP ON SUSTAINABLE FINANCE

The Technical Expert Group, which began meeting in July 2018, comprises 35 members from civil society, academia, business and finance, including the PRI, UNEP FI and 10 PRI signatories and 2 members of the SSE Initiative. It was formed as part of the Commission's Action Plan on Sustainable Finance, and was referenced in the package of legislative measures that followed on 24 May 2018.

The group will assist the Commission in developing an EU classification system – the so-called taxonomy – to determine whether an economic activity is environmentally sustainable. It will also support the Commission in the creation of an EU Green Bond Standard, in improving the disclosure of climate-related information, and by helping to develop low-carbon indexes. These latter are to be used by asset and portfolio managers as benchmarks for low-carbon investment strategies.

The group's work will start in early July 2018 and will finish by 30 June 2019, with a possible extension until the end of 2019. It will meet in plenary and in sub-groups, depending on the topics discussed.

The group will also reach out to relevant stakeholders, as achieving the goals of the Action Plan on Financing Sustainable Growth requires concerted efforts from all relevant actors.

The Commission services will also engage with experts from Member States and the European Parliament to inform them and collect feedback about the progress in implementing the Action Plan and on the progress of the Technical Expert Group's work.

A number of European and international institutions contributing to the development of sustainable finance have been invited to participate in the group as members or observers. They include representatives from the European Supervisory Authorities, the European Central Bank, multilateral development banks (including the European Investment Bank and the European Bank for Reconstruction and Development), the European Environment Agency, UNEP FI, the Central Banks and Supervisors Network for Greening the Financial System, and the Organisation for Economic Co-operation and Development.

**Composition of the Technical Expert Group on Sustainable finance**

| ORGANISATION | PERSON | SECTOR |
|---|---|---|
| AIG Europe | Dawn SLEVIN | Finance (insurance) |
| Allianz Global Investors | Steffen HOERTER | Finance (asset management) |
| Bloomberg | Curtis RAVENEL | Data provider |
| BNP Paribas asset management | Helena VIÑES FIESTAS | Finance (asset manager) |
| Borsa Italiana | Sara LOVISOLO | Finance (stock exchange) |
| Carbone 4 | Jean-Yves WILMOTTE | Research / consultancy |
| Cassa Depositi e Prestiti S.p.A. | Pierfrancesco LATINI | Finance (bank) |
| CDP | Nico FETTES | Civil society |
| Climate Bond Initiative | Sean KIDNEY | Civil society |
| Climate KIC | Sandrine DIXSON-DECLEVE | Civil society |
| EACB | Tanguy CLAQUIN | Trade and business association |
| EFFAS | Jose Luis BLASCO | Trade and business association |
| EnBW AG | Thomas KUSTERER | Business |
| Eurelectric | Jesús MARTÍNEZ PÉREZ | Business / Trade and business association |
| Finance Watch | Mireille MARTINI | Civil society |
| Green Finance Cluster Frankfurt | Karsten Loeffler | Academia, Research Institutes and Think Tank |
| GRI | Eszter Vitorino | Civil society |
| ICMA | Nicolas PFAFF | Trade and business association |
| KfW Bankengruppe | Karl Ludwig BROCKMANN | Finance (public bank) |
| Luxembourg Stock Exchange | Jane WILKINSON | Finance (stock exchange) |
| Mirova | Manuel COESLIER | Finance (asset manager) |
| MSCI | Veronique MENOU | Finance (index provider) |
| Nordea | Aila AHO | Finance (bank) |
| PRI | Nathan FABIAN | Civil society |
| RICS | Zsolt TOTH | Business / Trade and business association |
| SCOR | Michèle LACROIX | Finance (reinsurance) |
| SEB | Marie BAUMGARTS | Finance (bank) |
| Swiss Re Ltd | Claudia BOLLI | Finance (insurance/reinsurance) |
| Thomson Reuters | Elena PHILIPOVA | Data provider |
| Unilever | Michel PINTO | Business |
| WiseEuropa | Maciej BUKOWSKI | Academia, Research Institutes and Think |
| WWF | Jochen Krimphoff | Civil society |
| - | Andreas HOEPNER* | Academia, Research Institutes and Think |
| - | Brenda KRAMER** | Finance (pensions/asset manager) |
| - | Paolo MASONI* | |

* Members are appointed in a personal capacity.

** Member is appointed as a representative of a common interest shared by stakeholders.

# ANNEX 2

## PRI STAFF

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### GLOBAL NETWORKS AND OUTREACH

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Marie Luchet
Head of France
Paris

Don Gerritsen
Head of Benelux
Amsterdam

Yulia Sofronova
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### The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

## The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

### United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

### United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org