Summary[1] of the contributions by NGOs to the consultation document of the HLEG interim report on sustainable finance

The High-Level Expert Group (HLEG) on Sustainable Finance was set up by the European Commission at the end of December 2016 to advise on how to develop a comprehensive EU strategy on sustainable finance by providing operational and concrete recommendations to EU institutions.

The HLEG published its interim report in mid-July 2017 and presented the report at a stakeholder event on 18 July 2017. To gain targeted feedback on the analysis and reflections included in the interim report and provide information for the preparation of the final report, the HLEG issued a consultation questionnaire.

The responses received from non-governmental organisations (NGOs) are summarised in this overview. NGOs accounted for 19% of the responses received on the consultation (for all responses, see the summary of all the responses). These responses provided input for the HLEG deliberations. They raised issues that can be of interest during the political and public debates that will follow from the the final report of the HLEG on Sustainable Finance in the EU.

Question 1: What is the most important issue that needs to be addressed to move towards sustainable finance?

Sustainable finance should not take a "siloed" approach when it comes to the definition of environmental, social and governance (ESG) factors. Instead, it should be based on the Brundtland report, which covers human rights, as well as social and environmental aspects included in international agreements and soft laws.

The principles on which sustainable finance should move forward include:

- Policies and definitions need to be developed with all stakeholders, including civil society.
- The entire financial sector should be covered, including savings and debt resolution.
- ESG criteria should be strictly applied, including through binding regulation, minimal legal norms and exclusion criteria, e.g. for carbon-intensive industries.
- The fiduciary duty should be clarified and strengthened throughout the investment chain.
- The application of sustainability and ESG factors needs to be made transparent through verified reporting.
- ECB, supervisors and regulators need to use their full range of tools to steer finance towards sustainability and climate change goals.
- Education will need to change mind-sets and steer the sector towards long-term goals and sustainability.

Question 2: What should an EU classification system ('taxonomy') for sustainable assets and financial products include?

An EU taxonomy should include clear, standardised definitions and stringent exclusion criteria, while also remaining dynamic to take global emission pathways into account. The classification should be based on international and EU laws, norms and standards that identify what environmental, social

[1] This summary was made by SOMO, based on the database consultation responses published on the website of the HLEG on sustainable finance on 31 January 2018.

and governance criteria to be applied by the investor and investee entity, e.g. no contribution to climate change, human right breaches and corruption or fraud. It should also take into account the stability of the financial institution.

The sustainable assets and financial products included in the taxonomy should be useful for the full range and type of financial institutions and saving or investment products. The taxonomy should be transparent and also ensure the transparency of the projects.
The EU taxonomy should be developed with all the stakeholders.

Question 3. How can the EU ensure high-quality standards and labels for green bonds and other sustainable assets, and avoid misuse/green-washing?

To achieve high standards for green bonds, both a) content and b) process elements need to be taken into account.

a) Content:

Green bonds should be in accordance with the Paris climate agreement and related long-term plans of the EU member states, and be compatible with the underlying taxonomy. They should also respect all ESG aspects based on an agreed definition of ESG factors, including human rights and the UN Sustainable Development Goals (SDGs). Financial stability aspects should also be taken into account.

b) Process:

Green bonds need to comply with strict criteria and have measurable positive ESG impacts. Greenwashing is to be avoided through accountability and tracing mechanisms, including mandatory transparency, verification through certification agencies and compliance monitoring by a diverse group of stakeholders. Complaint mechanisms for consumers and investors should lead to remedies, where applicable, including the revocation of a green bond certification.

For a green bond label, the criteria should be well-defined in accordance with the highest standards. The label should be granted by the relevant national authorities. There should be ex-post controls on the use of the label with a monitoring and accountability process conducted by independent institutions.

Question 4: What key services should an entity like “Sustainable Infrastructure Europe” provide?

The key functions of an EU entity or agency for sustainable infrastructure could be:

- Capacity-building and technical assistance, including for local and regional authorities, on strategic, long-term and environmentally and socially significant European infrastructure projects.
- Advisory services for environment issues and social issues, including on how to consult with civil society.
- Information on how the investment fits into the local, national and European climate, as well as energy strategies and inclusive development strategies.
- Support for real energy transition projects, and not just large-scale projects and PPPs.
- Development of a network of local banks.

Criteria that should be applied by a Sustainable Infrastructure Europe entity include:

- A clear definition of what a “sustainable infrastructure” is and the exclusion of carbon-intensive projects.

- Accountability and appropriate benefit-risk sharing of the public budgets used.
- Proper legal and regulatory safeguards to mitigate well-known risks of PPPs, such as misuse of funds, tax evasion and lack of democratic oversight.
- Transparency regarding all PPPs.
- Safeguards to ensure strong social and governance standards, and the sustainable use of land and forestry.
- Projects should be set up from a sustainability perspective, and not adapted to the needs of the financial industry.

Question 5: Do you agree that short-termism is inherent in finance, especially financial markets, and is even an obstacle to long-term economic decision-making and investments that are essential for sustainability? Which sectors of the economy and financial system are particularly affected by the "mismatch of time horizons"?

Yes, short termism is considered a serious problem. It negatively affects all financial sectors and many economic sectors.

Which possible measures could resolve or attenuate this short-termism?

- Better binding regulation to incorporate long-term value creation, sustainability and ESG factors by all financial actors, e.g. higher risk weighting for carbon-intensive sectors, legal (fiduciary) duties for investors to integrate long-term ESG risks, a mandate for green macro-prudential policies and climate-related stress tests by supervisors.
- Rewarding and sanctioning performance on all ESG factors by decision-makers within the financial industry, e.g. through remuneration, trainings.
- Pricing measures: fiscal measures such as a financial transactions tax on high-frequency trading, higher prices and fees for unsustainable and short-term investments.
- Change reporting and accounting: reduce quarterly and annual reporting, account for true costs and natural capital dependencies, assess impacts and disclose information according to the guidelines set up by the industry-led Task Force on Climate-related Financial Disclosure (TCFD) and the EU Non-Financial Reporting Directive.
- Increasing the minimum holding of assets: minimum 5-year holding of bank shares, more long-term assets held by insurers.

Question 6: What key levers can the EU use to best align <u>investors and analysts</u> with long-term sustainability considerations in the real economy?

ESG needs to be included in all binding and enforceable legislation, as well as the clarification of fiduciary duty. Together with enhanced powers for ESAs, this would allow strong enforcement to ensure that ESG risks and two-degree compatibility are taken into account. This will also require enhanced compulsory transparency and reporting requirements, accounting, valuation models of "non-financials", long term measurements and forward-looking information (see, for instance, the TCFD proposals). Also, the ECB should align its asset purchasing programme with EU climate goals.

The EU should issue clear policies and a road map on climate change and other sustainability/ESG issues, including incentives or disincentives for short-termism. The EU should also be internationally active on these issues, including dealing with over-indebtedness.

Education and training within the financial sector are also an important lever.

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

It is important that authorities indicate which kind of projects are desired, i.e. through clear and consistent policy signals or obligations, and by designing large, long-term public investment programmes both nationally and EU-wide that are aligned with climate mitigation commitments. Capital-raising plans, and an incentive or co-investment framework for sustainable projects, should show investors how they can get involved. Support could also be achieved through the creation of national or regional 'green banks'. Greater support for early-stage ventures and technologies is crucial in order to start building a pipeline of projects ready for investment at scale.

Policy makers need to carefully check whether private investment in infrastructure or other sectors is necessary, and whether it will not (too much) debt. Related policies need to set standards to guarantee a sustainable outcome that includes strong social and governance safeguards, transparency when PPPs are implemented, the effective participation of local communities in defining their needs through "Free, Prior and Informed Consent (FPIC)" and avoidance of misleading claims.

The introduction of a binding regulatory and legislative framework needs to ensure that investment projects can be subject to high standards of public scrutiny, transparency and accountability. Binding rules for investors should include a clear fiduciary duty, and an obligation to exercise due diligence to avoid ESG damages and disclose ESG risks.

In the long run, a shift is required from the current corporate shareholder primacy that pursues short-term profits, to a system that ensures investments based on the concept of long-term sustainability. Hereby, financial companies have responsibilities to society as a whole and those affected by investments.

Other instruments to promote a pipeline of sustainable investment projects include:

- Change government accounting to allow deduction of investment spending from the deficit calculation rules of the Treaty on Stability, Coordination and Governance (TSCG).
- Set an effective carbon price that would unlock green projects by increasing their profitability compared to brown investments.
- Make environmentally-friendly technology cheap, and environmental destruction expensive. Support green FinTech that stimulates the market for green investment opportunities, e.g. by lowering the transaction costs for green issuers and equipping investors with trustworthy verification of green impacts.
- Make other private market products more aligned with sustainability, e.g. credit ratings.

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

- The most effective way to promote ESG consideration by CRAs are all the following measures as proposed, or a combination of the second and third of the proposed measures: creating a European credit rating agency designed to track long-term sustainability risks,
- requiring all credit rating agencies to disclose whether and how they consider TCFD-related information in their credit ratings, and
- requiring all credit rating agencies to include ESG factors as part of their rating.

This could be done through binding regulation (see Art. 173 of the French Energy Transition Bill), including an EU-wide definition of ESG criteria, as well as provisions to hold credit rating agencies to account for fully incorporating longer-term ESG risks in their assessments (also beyond TCFD-related information).

There is a need for greater independent supervision of the ratings assigned to companies' creditworthiness. ESMA has the responsibility to supervise, but does not want to interfere in the methodology of the CRAs. ESMA should receive a clear mandate to require, and give guidelines to, CRAs to incorporate climate and sustainability risks into their methodologies.

Besides creating a European credit rating agency, one or more of the existing domestic banks could collaborate to achieve the same objective. Alternatively, some smaller member states could team up to form a regional entity.

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

Capital requirements for banks could or should be adapted to the ESG risks, whereby lower rates could be applied than for brown short-term projects, to mortgage loans for sustainable or partially-ecological housing, and sustainable transport, long-term green and sustainable lending and project finance, and low-carbon and sustainable bank assets. The adjustments could be made in line with the lowered risk associated with sustainable projects without jeopardising financial stability. Supporting a brown-penalising factor could be a less risky option. Encouragement of green investment/financing and the penalising of brown investment/financing should be pursued at the appropriate level (e.g. based on project type or industry). Such reform in the calculation of risk-weighted assets to incentivise lending to greener sections of the economy could be carried out as part of the Capital Markets Union review.

Annual stress tests for banks should therefore include more ESG requirements. Also, binding regulation should oblige financial institutions to be transparent about their (project) lending, (own) investments and transactions regarding their ESG assessments, including for educational reasons. Banks should also be held legally responsible for causing, contributing or benefitting from serious ESG impacts or for failing to exercise due diligence to avoid such impacts.

Other measures to better involve banks in sustainability include:

- Requiring the allocation of a significant percentage of bank lending to long-term activities, or limiting credit extension to certain carbon-intensive or polluting activities through quantitative ceilings.
- Ensuring that all banks undergo a sustainability rating so that savers obtain full transparency as to what part of their savings goes into sustainable lending.
- Encouraging sustainable savings.
- Increasing literacy on sustainable finance issues, since customers are interested in sustainable finance.
- Separating retail and investment banks would be a significant step to ensure the goals of a sustainable financial system.
- Making it mandatory to respect internationally agreed norms and standards (i.e. through regulation), in order to internalise external costs.
- Promoting a broader use of approaches such as the Equator Principles.

- Promoting the use of FinTech solutions to help banks effectively channel capital into green projects and companies, based on informed decisions and FinTech applications to help trace green investments and validate the credibility of green products.
- Identifying and disseminating methodologies and datasets to monitor sustainability risks across different types of lending, industries and geographies.

Question 10: How can insurance companies be involved more strongly in sustainability, particularly through long-term investment?

Insurance companies should be subject to binding legislation and regulation that obliges them to be transparent about all their investments and their ESG impacts, to exercise due diligence to avoid ESG impacts, and to be accountable for contributing to negative ESG impacts. ESG measures should incorporate social and human rights dimensions. This should allow all insurers to undergo a mandatory ESG rating.

'Prudent person' rules should be expanded to include principles such as due diligence, care, skill and delegation, the duty to monitor, and the duty to protect policyholders' and beneficiaries' interests.

Measures should be taken to prevent insurers from primarily investing in short-term and unsustainable assets, while maintaining financial stability. These include:

- The "market-consistent" valuation of assets and liabilities should be adjusted.
- Long-term sustainability factors should be incorporated into each of the three pillars of the prudential framework for insurance under Solvency II and in the own risk and solvency assessment (ORSA).
- Valuation according to natural and social capital accounting should be encouraged.
- A reduction or ban on guaranteed returns for life insurance products should be implemented to avoid insurers investing in short-term assets, e.g. safe bonds.
- Restructuring the "seniority structure" of bonds by adding a separate taxonomy for green or "sustainable" products.
- Green FinTech could be used to help insurers work with big data and the IoT to make informed decisions and sustainability risk assessments.

In order to enhance the sustainability aspect of insurer investments, the following measures could be taken:

- Launching an EU survey of insurers on their model of the potential physical damages of climate change, and preparing an adaptation plan based on this survey (with member states and (re-)insurers).
- Legally obliging insurance companies to "green" their entire investment portfolios.
- Insurers should directly link a higher portion of their current fixed-income tilted portfolios to sustainable infrastructure or corporates, and should become active participants in subscribing to related bond issuances.
- Asset managers looking to serve the insurance community could innovate and offer performance of sustainable assets in both risk-adjusted and capital-adjusted terms.
- Climate stress-testing should be undertaken by regulators as a means of awareness raising.

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

It is essential for the "S" component to be fully taken into account when applying ESG and sustainability criteria and risk assessments.

Investments with social dimensions should ensure that investees respect international human rights laws, and collective and individual labour rights, while fiduciaries should assess the effect on their ultimate beneficiaries. Investors should involve civil society, and include accountability and oversight mechanisms. Investors should carry out extensive socio-economic evaluations, e.g. before tendering, and be discouraged from investing in high-risk jurisdictions where the rule of law is weak.

Other principles which the social dimension of investment should adhere to are: avoiding the externalisation of costs, considering the impact on women and to women's economic empowerment, taking affordability and inequality criteria into account, and preventing public debt-creating effects of blended finance.

Investments with social dimensions could range from active contribution to the SDGs to the creation of long-term quality employment for EU citizens and for those in the supply chain outside the EU.

Instruments for increasing investments with social dimensions include:

- Requiring investors and lenders to direct a significant percentage of their lending to long-term, socially sustainable projects.
- Covering financial inclusion, creditworthiness, whistle-blowing and gender aspects from a FinTech perspective.
- Supporting social impact bonds (SIBs) in cities and regions that are key enablers to many of the SIBs.

Other social dimension for the financial sector include:

- Ensuring that civil society and citizens have a clear say in the design and application of financial regulation.
- Engaging with investee companies to ensure the improvement of their labour conditions and human capital development practices.

Questions 12 and 13: Do you have any comments or additional suggestions on what the HLEG should cover in their work?

There should be a baseline definition of ESG and sustainability. It should illustrate the ESG framework, building on concepts such as alternative benchmarking (comparing the performance of a (financial) company against planetary and social boundaries and international agreements), a circular economy and the alignment of lending and investment portfolios with the SDGs.

More attention should be paid to the social objectives of sustainable development, e.g. SDGs related to poverty eradication, health, education and decent work. Respect for human rights should be central and its breach should be considered a systemic risk. Proposals should be made to tackle the financial sector's role in creating inequality. Sustainable finance should not be gender-blind, e.g. in its infrastructure proposals. More recommendations should cover EU policy commitments to achieve social objectives, both within the EU and outside the EU, e.g. related to the 2016 EU Communication on sustainability or the European Social Entrepreneurship Funds (EuSEF) regulations.

In order to avoid a bias towards the financial industry when developing sustainable finance, more attention should be placed on the participation of citizens, civil society and decentralised actors:

- The priorities of citizens, long-term and pension savers, and individual investors, should take precedence in the transition to sustainable finance; they should be protected against misleading information.
- Civil society should be involved in regulatory and legislative processes.
- The role of cities and provinces (or regions) should be better recognised as the "incubators" of sustainable investments.

Environmental challenges beyond climate change which could impact the resilience and stability of capital markets should receive due attention. These include water quality, biodiversity loss and the availability of natural resources. These factors could be addressed by taking natural capital into account (see natural capital information or accounting, Natural Capital Financing Facility, sustainability standards for agriculture).

The role of the European Central Bank is an important issue that is lacking in the interim report, particularly the ongoing asset purchase programme for corporate bonds (incl. fossil fuel company bonds), as well as monetary and macro-prudential policy in general.

The following sustainability issues related to the financial sector should be taken into account:

- Retail banking should be subject to strict ESG risk analysis.
- Derivatives trading and the reliance on shadow banking should be covered by sustainable finance, as they are part of the Capital Markets Union.
- The role of professional advisers, such as investment consultants (who are lightly regulated) and auditors, should be considered.
- The potential of FinTech solutions should be used as a lever for green finance and investment.
- The financial sector should be transformed to solidarity-based finance, and from a linear to a circular model.
- The establishment of a network of EU sustainable financial centres should be promoted by the EU.
- Debt sustainability should be considered a critical component in supporting developing countries to realise the SDGs and the 2030 Agenda.

Quite a few changes are also required in the economy and the corporate sector, including:

- The introduction of a more effective carbon price signal, supported by decisive EU ETS reform, a phasing-out of fossil fuel subsidies and common rules for carbon accounting.
- Sustainability disclosures for all companies need to be strengthened, including more rigorous TCFD proposals, and disclosures on the sustainability of issuers of green bonds.
- The introduction of enforcement mechanisms against breaches in ESG requirements. These could include provisions to bring legal proceedings before European courts against any (financial) company that causes harm or material risks when ESG factors are disrespected, as well as increasing supervisors' capacity building.
- The creation of alternative corporate business models and governance to guard against "shareholder primacy".

Issues that need to be covered to achieve a comprehensive approach to sustainable finance include:

- Focusing on shaping the attitudes and underlying values pertaining to sustainable finance.
- Ensuring follow-up on the HLEG final report, e.g. by establishing an observatory.
- Improving the green aspects of huge investments through public procurement (approx. 15% of the EU GDP).
- Showing how public finance plays a role, e.g. through the various EU funds and development banks (EIB and EBRD).