Sustainable finance in new EU legislation: focus on climate investment

by Myriam Vander Stichele

Three EU laws have been proposed by the European Commission (EC) on 24 May 2018 to promote the financial sector’s contribution to mitigating and adapting to climate change, and, to a lesser extent, embracing other sustainability considerations in its investment decisions. These legislative proposals should also diminish “ESG risks” or “sustainability risks”, namely risks that climate change, social exploitation and/or bad governance will reduce the value of financial assets and undermine financial stability.

The three proposals for Regulation are implementing some elements of the EC’s Action Plan on Financing Sustainable Growth (8 March 2018) and the final report of the High Level Expert Group on Sustainable Finance (31 January 2018). However, the EC’s ambition has been constrained by the fact that there is only one year left for these laws to be approved by the European Parliament and the finance ministers, i.e. before EU elections in May 2019.

The EC has narrowed the scope of “sustainability” and prioritised the encouragement of more investments to tackle climate change. The legislative package consists of:

1) Setting up a classification system, which will start with identifying activities that are officially recognised as climate mitigation and climate adaption;

2) Obliging investors to disclose how sustainability risks are taken into account in investment decisions, and how to do so;

3) Regulating what can be called “carbon benchmarks” and “positive carbon impact benchmarks”

Many of the details of the laws have been left out and will be enacted through implementation standards (delegated acts) after the laws have been adopted. In this way, the direct impact of the laws will depend on decisions taken later on how climate, environmental, social or governance risks and factors need to be integrated. The legislative proposals have also been constrained by stakeholders in the financial industry who do not want high costs associated with transforming their investments into climate friendly and sustainable activities, nor do they want prohibitions on financing activities that are not sustainable.

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1) A classification of sustainable activities: a taxonomy!

What is a green or sustainable investment? The financial industry wants a list of activities that are officially recognised as sustainable, or more precisely, climate-friendly, environmentally friendly, socially responsible, or based on good governance (ESG). This can be done by categorising different activities and providing criteria so that the financial industry can identify green or sustainable activities (by companies, projects etc.) to be financed. Such a classification system is referred to in EU jargon as a “taxonomy”.

The first legislative proposal is a Regulation to establish a framework within which classification of “sustainable investment” will be facilitated.² It sets out the conditions and criteria to gradually create a unified classification system (“taxonomy”). As a priority and in the first phase, the taxonomy will identify what economic activities could be considered as “substantially contributing” to, and “not substantially harming”, climate mitigation and climate adaptation, as well as pollution and waste prevention, healthy eco-systems and water protection. Advice on how to develop the criteria for these “environmentally sustainable” activities, with focus on climate, will come from a technical working group to be set up in June 2018 (see below).

In addition, a Platform on Sustainable Finance will be created in 2019. It will advise the EC on the further development of the taxonomy, including a social sustainability taxonomy in a much later phase (after 2021), and on the impact of the taxonomy.

What will a taxonomy achieve?

The EC intended to use a taxonomy for all kinds of financial products and applications, including for retail labels for sustainable (or climate-friendly) financial products. In the short term, the taxonomy will be used for instance for green bond standards. Financial products that claim to be environmentally sustainable or climate-friendly should fulfil the specified criteria of the taxonomy. On the one hand, this could provide clarity and avoid greenwashing financial products by making false claims about fighting climate change or contributing to sustainability objectives. On the other hand, it will mean that the financial industry will not build in-house capacities to assess what are climate mitigating and climate adaptation activities, as well as environmentally and socially sustainable activities, and might resort to box ticking during investment decision-making process.

Given the importance of the taxonomy, the financial industry has been lobbying hard to be part of the technical working group that will advise the EC on the criteria (metrics and thresholds) and definitions of the taxonomy and some of its applications. Civil society organisations are afraid they will be in a minority position with little resources. Up till 12 June 2018, the announcement of the members of the technical working group had been continuously delayed. Critics are sceptical whether the taxonomy will be defined in the near future and whether it will be stringent enough to avoid green washing. Some rather prefer a taxonomy for activities that should be forbidden because they substantially contribute to climate change. Others think a carbon tax might be more efficient and swift.

One issue of concern is whether the narrow definition of an activity that is considered as substantially contributing to climate mitigation and climate adaptation might have an unintended environmental or social impact (e.g. a windmill in the sea that disturbs the marine ecosystem and is constructed through exploitative labour practices). The “minimum guarantee” to avoid negative (unintended) consequences has been narrowed down in Article 13 to ensuring that core ILO labour standards are being respected. This minimum guarantee does not mention many other unintended social and human rights’ impacts a financed activity might have (e.g. on communities, in case of land grabbing). It also means that investors who have a duty to do an ESG risk analysis (see second legislative proposal) will have to assess the other environmental, social and governmental risks themselves for activities that are recognised by the taxonomy as climate mitigation and climate adaptation. Moreover, it will take a long time before a social taxonomy and a comprehensive sustainable taxonomy will be set up: Only after an evaluation is made by December 2021 will an extension to a social taxonomy be envisaged.

2) New disclosure obligations and future duties for sustainable investment

The second EC legislative proposal is a Regulation that will introduce transparency obligations for all kinds of investors, including those selling investment products. All 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 the remuneration policy is consistent with integrating sustainability risks. In order to incorporate the disclosure obligation, the EC proposal requires the amendment of various EU legislations that regulate different kinds of institutional investors and asset managers, e.g. insurance companies (Solvency II) and hedge funds (AIFMD), and those who issue investment products (i.e. an ‘omnibus’ law proposal).

The information disclosure and reporting requirements are more stringent for those financial products, e.g. mutual/investment funds, which claim to be sustainable investments. Sufficient information is to be given for each financial product beforehand, and up-to-date information needs to be available on the website concerning what the sustainability target is and what methods are used to measure the sustainability impact. A periodic report also needs to be published for each investment product on what the sustainable impact is. The details of these sustainability disclosure requirements will have to be worked out through delegated acts (i.e. technical standards that will need to be applied and supervised).

Beyond disclosure, this proposed Regulation also introduces (Art. 10) a delegated act by which the EC will strengthen the requirements to institutions for occupational retirement provisions (IORPs) to integrate ESG risks and ESG factors into their investment decision-making processes. This will be considered to be part of these institutions’ duties towards end investors and beneficiaries. In technical terms, Article 19 of the Directive IORP II will be changed so that the EC can adopt delegated acts that ensure that IORPs actually include ESG factors and risks in investment decisions and risk management processes as a way to implement the “prudent person” rule. The EC intends this delegated act to provide the details of the duty and wants to have it ready at the same time that the transparency law will have to be fully applied (12 months after entering into force).

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This Regulation refers to the legislations for some other investors, which require how to apply the prudent person principle, e.g. by insurance companies (Art. 132 Solvency II Directive) and on how hedge funds and other non-traditional investors should invest (Art. 12 of AIFM Directive). According to the EC’s explanation, these other laws already encompass sufficient delegated powers to the EC to incorporate ESG-related duties in the future.

Comments on the disclosure regulation

This legislation needs to be seen in the context of discussions on the “fiduciary duty” of investors, meaning that they will have to take long-term sustainability and ESG concerns of their end beneficiaries into account. The EC Action Plan on Financing Sustainable Growth intended to have the duty fully integrated in all investment related laws, but this was not considered feasible within the current legislative mandate. Therefore, the delegated acts should be used instead, as they also need to be applied, but will be enacted in a more indirect and less democratic way than the transparency obligations.

The proposed definition of “sustainable” includes respect for environmental or social or good governance principles, or all of these aspects taken together. This is a broad definition of a “sustainable” investment as it can cover only one of those aspects. Although “sustainability risks” are not defined, it is assumed that they will include risks that might come from negative ESG impacts on the environment and social issues, or from bad governance (e.g. corruption) in investment decisions (and related remuneration).

3) Preventing greenwashing of indexes

The third proposed Regulation will amend the existing benchmark regulation that stipulates minimum standards for benchmarks, or indexes, to avoid misleading consumers. The EC proposal introduces the minimum requirements and standards for the methodologies to be used, as well as disclosure obligations for issuing:

- “Low-carbon benchmarks” that should result in the related assets emitting less carbon than a standard benchmark or index;
- “Positive carbon impact benchmarks” whose related assets should save carbon emissions, i.e. in total emit less carbon than they produce.

In addition, 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 purpose of the Regulation is to better prevent “green washing” by providing investors with better information on the carbon footprint and saving of CO2 emissions, and the ESG factors, that are related to assets in which the index invests. However, the taxonomy on climate mitigation will not need to be used for the positive carbon impact benchmarks.

Note that benchmarks or indexes are important drivers of investment decisions because they are used to compose or compare many investment portfolio’s or funds and their profitability.

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4) **Investors have to ask about the sustainability preferences of their beneficiaries**

In addition to the three legislative proposals, the EC issued a public consultation because it wants to ensure that investment firms and insurance product distributors ask (potential) clients about their ESG preferences as well offer investment advice that includes ESG considerations or objectives. Technically, the EC wants to pursue amendments of the delegated acts that specify ‘suitable’ investments for (potential) clients in:

1) the Directive that regulates the offering of funds and other investment products (MIFID II), and
2) the Directive that regulates the distribution of insurance-based investment products (IDD).

5) **Overall assessment**

The different proposals that regulate investments in sustainability are often limited to climate change issues, but do not encompass regulating, prohibiting or sanctioning the financing and investing in activities that destroy the climate and the environment, use socially abusive practices or are based on bad governance (e.g. corruption, tax dodging). They deal with investment decisions (which especially apply when investing in shares and bonds), but not with decisions about loans by banks, nor other financial activities such as speculative derivatives trading.

The proposed legislation will help to prevent green washing and build trust that investors’ claims to be green or sustainable are actually having an impact. The question is whether the proposed measures will therefore make it more attractive to invest in sustainability. Or will they make it costlier compared to non-sustainable investments that can merely be covered by policies that state they have no ESG considerations (see second legislative proposal)? Whereas the financial industry resists too stringent requirements for sustainable investments, as this makes such investing costlier, it refuses to add sustainability (disclosure) requirements and ESG risks assessments for all its mainstream investments and financial products because that would expose the ESG externalities and make mainstream investments more expensive while, in fact, sustainable products more attractive.

Critics question whether the proposed legislation will re-orient sufficient capital to tackle climate change, let alone support activities with positive long-term ESG impacts, both within the EU and for EU investments in other parts of the world. The scattered EU legislation and complex legislative process undermine the EC in its efforts to act swiftly on the EC’s ambitions developed over the last year in its Action Plan on Financing Sustainable Growth (with high priority to climate change). The proposed legislations only cover parts of the Action Plan.

Quite a bit of the legislation is about integrating ESG risks, which means assessing whether investing in activities with negative social and environmental impacts or based on bad governance, will diminish or nullify the value of the investment. These financial, “material” impacts do not cover the

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full spectrum of the sustainability discussion, including the long-term and material or non-material impacts on beneficiaries and other people or on the environment, or contribution to the UN Sustainable Development Goals, etc. Such long term impacts might be part of the sustainability preferences of clients.

The definition of ESG risks and factors, and what “sustainable” investments are, often remains unclarified in many reports and discussions. It also varies in each of the EC proposals for legislative changes described above. While the law that will establish a taxonomy defines what an “environmental sustainable investment” is, the law that requires disclosure on sustainable investment and risks defines “sustainable investments” as being respectful of the environmental or social or good governance principles, or altogether. In contrast, the proposal to amend the delegation on how issuers of investment products have to advise potential clients (and take their sustainable preferences into account) provides a more comprehensive definition, namely:

- “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 [the taxonomy Regulation].
- “Social investment” means an investment in an economic activity that contributes substantially to a social objective, and in particular an investment that contributes to tackling inequality, an investment fostering social cohesion, social integration and labour relations, and an investment in human capital or economically or socially disadvantaged communities.
- “Good governance investment” means an investment in companies that follow good governance practices, and in particular companies with sound management structures, employee relations, remuneration of relevant staff and tax compliance.

These definitions will be contested for quite some time. For instance, although the preambles of the proposed legislations refer to human rights, there are no references to human rights included in “social investments” and the social consequences to be avoided when defining environmental sustainable investments (taxonomy) only refer to core labour rights.

All in all, these proposals are a step forward in regulating effective sustainability in financial and investment decisions, which go beyond the many voluntary, often industry based, initiatives. Remember that in 2016 the EU had no policy whatsoever about sustainable finance.