

# Supervising the environmental, social and governance impact of finance

How to reinforce the role of European and national supervisory authorities?



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## Colophon

Supervising the Environmental, Social and Governance (ESG) impact of finance:  
How to reinforce the role of European (ESAs) and national supervisory authorities?

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# 1. Summary

The EU debate and policy on sustainable finance adds another set of potential tasks to the European and national supervisors of banks, insurers, asset managers, pension funds and other actors of the financial sector.

This paper shows that some of these supervisory tasks can already be performed, given current legal mandates of European and national supervisory authorities. In the context of the EU legislative review of the European Supervisory Authorities' (ESAs), as well as the review of some EU sectoral laws, such as the EU banking laws, this paper assesses what further legislative revisions would be necessary to integrate environmental, social and governance (ESG) considerations firmly and more explicitly into the supervision of the European financial sector. The paper builds upon the recommendations of the High Level Expert Group on Sustainable Finance, the European Commission's Action Plan for Financing Sustainable Growth and the related legislative proposals for sustainable finance published on 24 May 2018. It advises on how to complement the European Commission's proposal for the revision of the mandates of the ESAs and how to strengthen the ESAs and national supervisors' scope through EU financial sector laws. This paper intends to make a contribution to the discussions by those engaged in the EU financial reform process.

This paper **first** explains why ESG and sustainability considerations need to be integrated in supervision. The **second chapter** explains the role of the ESAs in the EU's supervisory landscape. **Thirdly**, proposals are made to strengthen ESG supervision by the ESAs. The **fourth chapter** provides a short summary of the European Commission's Action Plan on Financing Sustainable Growth and the related legislative proposals made on 24 May 2018, with focus on supervisory tasks. **Fifthly**, the paper exposes that ESG considerations are mostly not included in today's sectoral laws that determine supervision at national and EU level. Based on findings of supervisors' day-to-day experiences, the final **chapter** and **annexes** recommend legislative amendments that would enable and enhance national ESG supervision in the whole of the EU.

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## 2. The need to integrate ESG considerations in supervision

In its [final report](#)<sup>1</sup>, the High Level Expert Group on Sustainable Finance (HLEG) recommended “integrating sustainability firmly in the governance of financial institutions as well as in financial supervision”<sup>2</sup>. It observed that “a comprehensive approach is needed to change the way in which the duties of financial institutions, their governance, risk management and supervision are delivered”<sup>3</sup>. This means that supervision has an important role in monitoring and enforcing the laws and standards that ensure that banks, insurers, pension funds, asset and fund managers, and other actors in the financial sector, integrate environmental, social and governance (ESG) risks and sustainability considerations. Such supervisory role would reinforce the contribution of the financial sector to a sustainable economy and society.

New risks such as ESG risks and opportunities to promote sustainability are changing the financial sector and require adaptations to the national and European supervisory framework and approach. Moreover, the financial sector has a key role to play in ensuring the transition to a low-carbon and more energy-efficient economy to combat climate change. It is also expected to contribute to EU commitments to the UN Sustainable Development Goals.

A strong coordination and convergence of supervisory tools and practices towards sustainability is necessary at EU level. The [legislative proposal](#) of the European Commission (EC) to review the law that established the European Supervisory Authorities (ESAs)<sup>4</sup> is meant to be consistent with the Energy Union Strategy and the EU's commitments to the Paris climate agreement, a circular economy and the UN Sustainable Development Goals. The EC's proposal is in line with protection of fundamental rights and the environment, and observance of the principles recognised, in particular, in Article 3.3 of the [Treaty on the European Union](#) (TEU)<sup>5</sup>. It contributes to the objective of sustainable development, which is also laid down in Article 37 of the Charter of Fundamental Rights of the European Union. The question is, however, whether the legislative proposals can indeed live up to those provisions.

Supervision that relates to sustainability, or ESG risks, ESG factors and ESG impacts, and/or UN Sustainable Development Goals, is relatively new and often starts with looking at the impact of credit and investments on climate changing activities, and the longer term risks of climate change on the financial sector. A group of (national) supervisors and central banks<sup>6</sup> regard supervising environmental, social and governance considerations, and especially climate change related risks, as relevant for financial stability and thus already included in their current supervisory mandates. However, many supervisors regard an explicit assignment, as well as sufficient capacity and competences, necessary to actually go and apply ESG supervision.

The proposals regarding supervision for sustainable finance such as those that the EC had included in its legislative proposal to review the EU laws on establishing the ESAs, might still not be sufficient. To

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<sup>1</sup> HLEG, Financing a sustainable European economy – Final Report 2018, [31 January] 2018, [https://ec.europa.eu/info/publications/180131-sustainable-finance-report\\_en](https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en) (viewed 8 February 2018).

<sup>2</sup> Idem, p 5: Recommendation 8.

<sup>3</sup> Idem, p. 12.

<sup>4</sup> EC, Review of the European Supervisory Authorities - Proposal for a regulation (COM(2017)536, 20 September 2017, [https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536\\_en#https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536_en#https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536_en) (viewed 10 October 2017).

<sup>5</sup> Consolidated version of the Treaty of the European Union, 26 October 2012, [https://eur-lex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC\\_1&format=PDF](https://eur-lex.europa.eu/resource.html?uri=cellar:2bf140bf-a3f8-4ab2-b506-fd71826e6da6.0023.02/DOC_1&format=PDF) (viewed 12 March 2018).

<sup>6</sup> These supervisors are coordinating in the Network for Greening the Financial System: <https://www.banque-france.fr/en/financial-stability/international-role/network-greening-financial-system>; see also below.

provide the necessary assignment and guidance that some European supervisory authorities would need to clarify their ESG and sustainability mandate, amendments of its different tasks, powers, activities and functioning are useful. Given that within the EU, most supervision is still done by the national supervisors, whose quality and coherence the ESAs have to promote, sectoral EU legislation ('Level 1 legislation') on banks, insurers, asset managers, pension funds, investment funds and other financial market players would also need to be amended. These sector-specific legislations provide the adequate scope for the ESAs.

ESG considerations were already included in EU legislation on occupational pension funds (IORP II) as well as on complex retail investment products (PRIIPs) with environmental and social objectives (see chapters 4-6). In addition, some parts of the EC Action Plan on Financing Sustainable Growth (APFSG) and related legislative proposals will affect national supervisory practices. These different aspects will be elaborated in this paper, with proposals on strengthening the ESG mandate of the European and national supervisors, including amendments in the annexes.

## 3. Why are ESAs important for supervisors?

### 3.1. The relation between national and European supervisors

The role of national prudential supervisors in the financial sector and that of the European Central Bank (ECB) as supervisor of the most significant banks in the Eurozone, is to assess and change, as needed, the way that banks, insurers, and institutional investors (such as asset managers and pension funds) assess their risks. The way in which these financial institutions allocate adequate capital reserves to cater for unexpected losses must be assessed accordingly, in order to guarantee financial stability. As regards financial markets and the protection of consumers and investors engaged in financial services, ensuring their orderly functioning is the role of the competent national market conduct supervisors and, for a few financial actors, the European Securities and Markets Authority (ESMA).

This supervision often entails assessing information and processes that are not visible to the public. Supervisors can directly request information from their supervised entities and intervene to have behaviour changed or improve the financial situation of the supervised entity.

The current debate on whether and how to include ESG factors in financial risk assessments by supervisors, questions whether such inclusion is already an obligation today for lending, underwriting and investment assessment processes by financial players. A global group of supervisors and central banks, coordinated in the Network for Greening the Financial System, believe that ESG factors and especially climate related risks, should be included in the risk assessments of debtors, investees and underwritten risks. The Network for Greening the Financial System is composed of supervisors and central banks of seven EU countries (Austria, France, Germany, Spain, Sweden, The Netherlands, the United Kingdom) and the ECB, as well as four non-EU supervisors (China, Mexico, Morocco, Singapore) with the Bank for International Settlements (BIS) and OECD as an observer.<sup>7</sup> These supervisory authorities requested banks, pension funds and insurance undertakings to answer how as financial actors they include especially climate-related risks in their risk assessments. Other supervisors are of the view that they are only bound thus far by the ESG provisions in EU legislation, namely in the [Directive on the Activities and Supervision of the Institutions for Occupational Retirement Provision](#)<sup>8</sup> (IORP II, Art. 19, 21, 25, 28, 41) and the [Regulation on key information documents on Packaged Retail and Insurance-Based Investment Products](#)<sup>9</sup> (PRIIPs, Art. 8 and (in the future) Art. 33).

Supervision in EU law is mostly mandated to national authorities. The latter also authorize an entity to do business in a certain market, be it banking, insurance, asset management or pension fund management. Under the Single Supervisory Mechanism of the Eurozone, the ECB is responsible for supervision of the largest and most significant 118 banking groups, and is mandated to authorize new credit institutions in cooperation with national supervisors. Other banking and credit institutions, thousands, are supervised by national supervisors.

All national competent supervisory authorities are members of one or more ESAs.

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<sup>7</sup> "The Network brings together the BaFin, the Bank al Maghrib, the Banco de España, the Banco de Mexico, the Bank of England, the Banque de France and the French Autorité de Contrôle Prudentiel et de Résolution (ACPR), De Nederlandsche Bank, the Deutsche Bundesbank, the European Central Bank (ECB), the Swedish Finansinspektionen, the Monetary Authority of Singapore, the Oesterreichische Nationalbank (OeNB) and the People's Bank of China as well as, as observer the Bank for International Settlements (BIS) [and the OECD]." More members are expected to join. Source:

<https://www.banque-france.fr/en/financial-stability/international-role/network-greening-financial-system/about-us> (viewed 30 May 2018).

<sup>8</sup> Directive (EU) 2016/2341 on the activities and supervision of institutions for occupational retirement provision (IORPs), 14 December 2016, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L2341&from=EN> (viewed 10 March 2018).

<sup>9</sup> Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R1286&from=EN> (viewed 10 March 2018).

The ESAs consist of:

- ❑ the European Banking Authority (EBA)
- ❑ the European Insurance and Occupational Pensions Authority (EIOPA)
- ❑ the European Securities and Markets Authority (ESMA)

The EBA, EIOPA and ESMA, can cooperate, coordinate, launch joint consultations and present common advice through the ESAs 'Joint Committee'.

The ECB is member of the EBA and may work together with other ESAs.

The European Systemic Risk Board (ESRB) has a complementary role and ESAs have to closely cooperate with the ESRB. The ESRB monitors systemic risk, which is macro-prudential supervision, and recommends the supervisory authorities to apply additional measures in the event of significant market-wide developments and risks. It is chaired by the President of the ECB, and brings together representatives of the national central banks of EU countries and the Chairs of the three ESAs.

The EU supervisory network is referred to as the European System of Financial Supervision (ESFS).

### 3.2. The roles of the ESAs in supervision in the EU

The main tasks of the ESAs consist of contributing to the consistent application of EU financial laws, create a common supervisory culture and speed up regulatory convergence by issuing guidelines. Also, they draft regulatory technical standards (referred to as "Level 2") as required by EU law and they give other advice to the EC when requested or on their own initiative. They do so within their legal mandate, and by sharing capacity and staff from the related supervisors.

The EU laws that establish each of the ESAs, and which are being reviewed by the EC legislative review proposal (see chapter 3) are:

- ❑ Regulation 2010/1093, establishing the European Banking Authority (EBA)
- ❑ Regulation 2010/1094, establishing the European Insurance and Occupational Pensions Authority (EIOPA)
- ❑ Regulation 2010/1095 establishing European Securities and Markets Authority (ESMA)

The **scope** of the ESAs is restricted by Article 1(2) of each ESA Regulation, which refer to the specific applicable sectoral legislative frameworks, i.e. the Level 1 Regulations and Directives themselves, which apply to a particular financial sector such as banks, pension funds, insurers companies and asset management companies.

For EBA and ESMA, Article 1(5) adds a **general assignment**: "The objective of the Authority shall be to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses." For the European Insurance and Occupational Pensions Authority (EIOPA), this regards Article 1(6).

The specific **tasks** of the ESAs are elaborated upon in Article 8(1), listing tasks all about informing and contributing and fostering common EU high-quality supervision, assessing market developments, and fostering depositor and investor protection. The ESAs have no direct supervisory mandate, except for ESMA in the area of credit rating agencies and trade repositories.

The **powers** given to the ESAs to perform their tasks are listed in Article 8(2). They aim at supporting the regulatory process with advice, opinions, draft technical standards following instructions in Level 1 legislation, non-binding guidelines, common methodologies and information sharing. The ESAs further

stimulate the convergence of supervisory practices, i.e. the national implementations and applications of the respective sectoral EU laws, with guidelines and non-public supervisory handbooks, which do not have the legal enforceability of the Level 1 legislation.

Decisive intervening powers by ESAs are restricted to emergency situations and cases of disagreements between national supervisors (Articles 18 and 19). ESAs are also allowed to provide advice to the EU institutions that initiate (EC) and decide (European Parliament, Council of Ministers) on financial Level 1 legislation but ESAs are not part of the advisory committees or as observers of these institutions.

## 4. Which legal provisions will strengthen ESG supervision by the ESAs?

Supervisors in the EU need two things in order to justify and feel accountable for their work: a mandate to do so, including a budget, and specific provisions in the sectoral legislative framework applying to their supervised entities, which they will then monitor and enforce. Both are equally important, they cannot supervise without a mandate and budget, and they cannot enforce without explicit provisions in the law. Supervisors are allowed to impose measures and sanctions onto supervised entities only when the law says so.

### 4.1. What can ESAs already do?

The ESAs can, within their current mandates, already start understanding this new market development by monitoring and assessing. Furthermore, they can collect the experience of supervisors from Austria, France, Germany, Spain, Sweden, The Netherlands, and the United Kingdom, who are part of the Network for Greening the Financial System. Those supervisors have already started applying part of ESG supervision and are sharing experiences and best practices on the supervisory and macro-financial dimensions of climate-related and environmental risks, as well as on options to scale up green financing.<sup>10</sup> This could inform supervisors who still feel that they lack these legal and operational competences regarding environmental, social or governance risks, including climate risks, and sustainability considerations as part of their financial stability mandate.

The members of Network for Greening the Financial System consider that their duty to safeguard financial stability includes monitoring climate risk. An important choice for the ongoing debate on the ESA-mandates is whether ESG is regarded as an extra element of risk, or whether ESG considerations alter the assessment of the main risk types such as credit risk, market risk, underwriting risk, etc.

### 4.2. The EC's legislative proposal to clarify the ESA mandates related to sustainable finance

The ESAs' formal mandate is based on the scope of their actions and powers, which is laid down in Article 1(2) of each ESA regulation, enumerating the sector-related Level 1 legislation. In addition, ESAs cannot undertake initiatives outside the scope that is established in the sector-related Level 1 legislation, and need a specific mandate to be given in a Level 1 regulation or directive (see second part of this paper). Nevertheless, specifications related to ESG considerations can be included in the different articles throughout the ESA review, which specify the different powers as well as tasks and activities the ESAs have to undertake within their scope.

In its [proposals issued in September 2017 to review the EU Regulations that establish the ESAs](#)<sup>11</sup>, the EC reveals its wish to have the ESAs sustainably reinforce the stability of the financial system (recital 32), including by considering risks posed by ESG factors. However, it is still being debated whether all stakeholders agree that this is meant by protecting the public interest as stated in Article 1(5) or 1(6) of each ESA Regulation.

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<sup>10</sup> See the work programme of the Network published on 29 May 2018: [https://www.banque-france.fr/sites/default/files/medias/documents/press-release\\_2018-05-29\\_publication\\_of\\_the\\_mandates\\_of\\_the\\_ngfs\\_technical\\_workstreams.pdf](https://www.banque-france.fr/sites/default/files/medias/documents/press-release_2018-05-29_publication_of_the_mandates_of_the_ngfs_technical_workstreams.pdf) (viewed 30 May 2018).

<sup>11</sup> EC, Review of the European Supervisory Authorities - Proposal for a regulation (COM(2017)536, 20 September 2017, [https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536_en) (viewed 22 September 2017).

The explanatory memorandum to the ESA review proposal reveals that the EC seems to see a stepped approach for the ESAs in connection to their ESG tasks<sup>12</sup>:

- ❑ First, monitor how financial institutions identify, report, and address risks that ESG factors may pose to financial stability;
- ❑ Second, provide input to the EC to have ESG factors included in financial sector legislation.

The explanatory memorandum amongst others says: *“All the three ESAs will be under an obligation to take account of risks related to environmental, social and governance factors when carrying out their tasks. This will also enable the ESAs to monitor how financial institutions identify, report, and address risks that environmental, social and governance factors may pose to financial stability, thereby rendering financial market activities more consistent with sustainable objectives. The ESAs can also provide guidance on how sustainability considerations can be effectively embodied in relevant EU financial legislation, and promote coherent implementation of these provisions upon adoption.”*

The legal hook for ESAs to monitor ESG risks, is their mandate to ensure financial stability and consumer protection. However, that is not reflected in the EC’s amendments of Article 8, which only refer to ESG factors as a general consideration that the ESAs need to take into account. In addition, the ESA review package does not include changes to the Level 1 sectoral financial legislation as it is not part of the ESA review package, regarding the inclusion of ESG as an explicit risk.

The actual amendment to the ESAs’ mandates in Articles 8 of all three regulations is worded as follows (see Box): *“When carrying out its tasks in accordance with this Regulation, the authority shall take account of technological innovation, innovative and sustainable business models, and the integration of environmental, social and governance related factors.”* This is a very open invitation to consider ESG factors (and innovation) in any of the ESA tasks.

#### **Box: The EC legislative proposal to include ESG supervision**

As part of the ESAs legislative review proposal (September 2017), the EC has incorporated its intentions to promote ESG supervision into all three laws (‘Regulations’) that establish each of the ESAs. More specifically, the EC proposes to amend Article 8 that defines the ESAs tasks and powers, to add a new sub-paragraph (c) in the existing paragraph (1a) of Art. 8 of the EBA Regulation, and to add an identical new paragraph (1a) in Article 8 of EIOPA’s and ESMA’s Regulations, which states: *When carrying out its tasks in accordance with this Regulation, the Authority shall **“take account of technological innovation, innovative and sustainable business models, and the integration of environmental, social and governance related factors.”***

**Source:** EC, Review of the European Supervisory Authorities - Proposal for a regulation (COM(2017)536, 20 September 2017,

[https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536\\_en#https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536_en#https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536_en)

### **4.3. How to strengthen the ESA mandates related to sustainable finance?**

Including ESG considerations in each of the different activities, as laid out in the Regulations, ESAs have to undertake within their scope, tasks and powers, could be clarified through specific amendments for each of these activities.

To complement the EC proposal, ESG could be integrated into existing provisions, such as through amendments referring to the existing articles that cover:

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<sup>12</sup> Ibidem, p. 19.

- ❑ The **scope** (Art. 1): can include that the authority shall act “taking account of technological innovation, innovative and sustainable business models, and the integration of environmental, social and governance related factors” to ensure effective application of sectoral legislation.
- ❑ **Cooperation** with the other ESAs and the ESRB (Art. 2.3.): could include cross-sectoral consistency on ESG supervision.
- ❑ **Tasks and powers** (Art. 8): can include taking account sustainability and ESG considerations when providing advice to EU institutions and ESG risks when drafting technical standards.
- ❑ **Issuing guidelines** (Art. 16): should ensure that guidelines do not increase ESG risks.
- ❑ **Common supervisory culture** (Art. 29): can be improved by information exchange among supervisors on climate and ESG risks and promoting climate forward looking scenarios.
- ❑ **Assessment of market developments** (Art. 32): should include assessing climate and ESG risks and market trends related to sustainability and ESG considerations, and developing a methodology for such assessments (including regarding forward looking scenarios).
- ❑ **International relations** (Art. 33): could include that ESAs could develop and publish international arrangements to enhance the efficiency and effectiveness of ESG supervision.
- ❑ **The stakeholder group** (Art. 37): should include expertise in the area of sustainability and ESG issues.

These amendments, when adopted, could open immediate opportunities for the ESAs to start including ESG in their operations, while respecting current sector-specific Level 1 legislation. For the specific ESAs this could mean:

- ❑ ESMA can include requirements for reporting on climate and wider sustainability risks in guidelines on risk factors in prospectuses.
- ❑ Following Article 8(3) of the Regulation on Credit Rating Agencies, ESMA can assess current practices in the credit rating market, analyse the extent to which ESG considerations are taken into account, and integrate climate and wider sustainability considerations in guidelines on the validation and review of Credit Rating Agencies’ methodologies in order to ensure that a “credit rating agency shall use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back testing”.
- ❑ All ESAs can collect evidence of undue short-term pressure from capital markets on corporations given their assignment in Article 1(5) or 1(6).
- ❑ EBA and EIOPA can include ESG scenarios in stress testing scenarios.

Of course, ESG risks are not confined to European Member States, and typically call for international coordination and information sharing. The general objective to strengthen international supervisory coordination is included in the ESA Regulations’ Article 1, and further elaborated upon in Articles 23 and 33. These two articles could be further specified to explicitly include ESG.

As explained in this chapter, the EC’s intention is clear: it expects the ESAs to go and integrate ESG considerations in basically everything they do. However, legal certainty and clarity will be strengthened by including this obligation explicitly in sectoral legislation as well. More powerful than amending the ESAs mandate, tasks and power, would be amendments to the Level 1 sector-specific legislative frameworks. The reasons are twofold: one, these sectoral Level 1 laws are listed in the ESA regulations’ Article 1 and provide the scope for each of the ESA about the sectors they (indirectly) oversee. Two, different national supervisors need to enforce the sectoral legislation. This will be further developed in chapter 5 and 6 of this paper and in the annexes.

## 5. The EC's Action Plan on sustainable finance and new implementing legislative proposals

When clarifying and strengthening the mandates, tasks and powers of the national and European supervisors, one needs to take into account of the EU's sustainable finance policy and related legislative initiatives, i.e. reviews of existing laws as well as new legislation. Following the final report on sustainable finance by the HLEG, published on 31 January 2018, the EC developed a new policy on sustainability in the financial sector.

### 5.1. Some important elements of the EC Action Plan on sustainable finance

On 8 March 2018, the EC published its “[Action Plan on Financing Sustainable Growth](#)” (APFSG)<sup>13</sup>. An overarching motivation is that the EC is committed within the framework of the Capital Markets Union (CMU) to strengthen the EU's leadership on sustainable investment and finance.

Besides the actions announced in the APFSG, further initiatives are planned, such as actions on the circular economy as part of a Reflection Paper 'Towards a Sustainable Europe by 2030'. The EC has also launched [a multi-stakeholder platform](#)<sup>14</sup> to exchange best practices on the implementation of UN Sustainable Development Goals in the EU. These initiatives will not focus on the financial sector.

The APFSG aims are related to the two urgent imperatives which the HLEG mentioned in its final report, namely 1) the contribution of finance to sustainability, inclusive growth and society's long term needs, and 2) the strengthening of financial stability. The EC does not explicitly link each action to one of the two HLEG imperatives but has threefold aims:

- 1) Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
- 2) Manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- 3) Foster transparency and long-termism in financial and economic activity.

The financial stability argument is only once explicitly referred to, namely in the actions related to incorporating sustainability in prudential requirements (Action 8). In the EC's Action Plan, financial stability is not an overarching argument.

Note that the legislative review of the ESAs referred to in this paper, was launched before the APFSG, namely in September 2017<sup>15</sup>. The ESA review was inspired by the [interim report of the HLEG](#)<sup>16</sup> issued in July 2017. In its final report, the HLEG identified that for effective implementation of most of its recommendations, ESAs would have a role to play. This has been reflected in the APFSG.

Relevant new tasks for, or specific actions by, supervisors integrated in the APFSG, relate to actions 1, 4, 6, 7, 8 and 10 as follows:

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<sup>13</sup> EC, Action Plan: Financing Sustainable Growth - Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic And Social Committee and the Committee of the Regions, 8 March 2018, [https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth\\_en](https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en) (viewed 8 March 2018).

<sup>14</sup> EC, The high level multi-stakeholder platform on the implementation of the Sustainable Development Goals, [https://ec.europa.eu/info/strategy/international-strategies/global-topics/sustainable-development-goals/multi-stakeholder-platform-sdgs\\_en](https://ec.europa.eu/info/strategy/international-strategies/global-topics/sustainable-development-goals/multi-stakeholder-platform-sdgs_en) (viewed 15 April 2018).

<sup>15</sup> EC, Review of the European Supervisory Authorities, 20 September 2017.

<sup>16</sup> HLEG, Financing a sustainable European economy – Interim Report 2018, July 2017, [https://ec.europa.eu/info/publications/170713-sustainable-finance-report\\_en](https://ec.europa.eu/info/publications/170713-sustainable-finance-report_en) (viewed 18 July 2017): see for instance pages 24 and 33, and recommendation 7 (p. 59).

- **Action 1** calls for the creation of a unified EU classification system ('taxonomy') to clarify which activities are to be considered 'sustainable'. The purpose is to provide detailed information through screening criteria, thresholds and metrics to be applied to activities in relevant sectors. This categorisation will be gradually developed and included in EU legislation. It can be used by different financial actors and EU (legislative) initiatives such as an EU Ecolabel framework (see Action 2.3.). Establishing a climate, environmental and sustainability taxonomy, or categorisation of financed activities, is a primary objective of the APFSG, to be advised by a multi-stakeholder [technical working group](#)<sup>17</sup> within a defined deadline, which will be a challenge to be met.
- **Action 4** calls for financial advisors having to incorporate sustainability when offering of investment choices and assessing clients' preferences and needs (offering 'suitable' products, i.e. 'suitability assessment'), as required in the [Markets in Financial Instruments Directive](#) (MiFID II)<sup>18</sup> and the [Insurance Distribution Directive](#) (IDD)<sup>19</sup>. The Action Plan proposes that the EC amends the delegated acts of MiFID II and IDD, based on which ESMA should amend guidelines on how to include sustainability in the suitability assessment. It is important to recall that it is legally challenging to make such amendments as suggested by the Action Plan when the Level 1 text does not provide the delegation. It would be easier for the EC to amend the Level 1 texts of MiFID II and IDD first, as is suggested in chapter 5-6 and Annex III in this document.
- **Action 6** calls for better integrating sustainability in ratings and market research. The EC therefore invites ESMA to assess how ESG considerations are taken into account in current credit rating practices and to include environmental and social sustainability information in its (disclosure) guidelines.
- **Action 7** calls for a requirement to integrate sustainability considerations in the investment-making process of the different by the different institutional investors and asset managers as a fiduciary duty to act in the best interest of their end-investors/beneficiaries. This requirement should be clarified in the different related EU legislations, which can be done through an 'omnibus' legislation. In order to increase transparency towards end-investors, institutional investors and asset managers should disclose if and how they integrate such sustainability factors and risks in their investment decisions.
- **Action 8** calls for a better reflection of risks associated with climate and other environmental factors to be incorporated in prudential requirements of banks ([Capital Requirement Regulation](#)<sup>20</sup>/[Capital Requirement Directive IV](#)<sup>21</sup> (CRR/CRD)) and other institutions, such as insurers ([Directive on Insurance and Reinsurance](#) (Solvency II)<sup>22</sup>). The EC will explore the feasibility of including such risks and sustainable assets in banks' risk management policies and potential calibration of capital requirements for banks as part of CRR/CRD, which was under review at the time the APFSG was launched. The EC will need the EP and the Council to work on such amendments for the new law. The political discussion will relate whether 'green' financing and sustainable assets will be considered less risky ('green supportive factor') or whether

<sup>17</sup> EC, Call for applications for the selection of members of the technical expert group on sustainable finance, 8 March 2018, [https://ec.europa.eu/info/publications/180308-sustainable-finance-call-for-applications\\_sy](https://ec.europa.eu/info/publications/180308-sustainable-finance-call-for-applications_sy) (viewed 10 March 2018).

<sup>18</sup> Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, 15 May 2014, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN> (viewed 10 March 2018).

<sup>19</sup> Directive (EU) 2016/97 on insurance distribution (recast), 20 January 2016, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L0097&from=en> (viewed 10 March 2018).

<sup>20</sup> Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 26 June 2013, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN> (viewed 25 May 2018).

<sup>21</sup> Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, 26 June 2013, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN> (viewed 25 May 2018).

<sup>22</sup> Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), 25 November 2009, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0138&from=EN>; recast: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02009L0138-20140523&from=EN>, 23 May 2014 (viewed 25 May 2018).

environmentally non-friendly lending will require higher capital reserves ('brown penalising/corrective factor'). The EC states in the Action Plan that the calibration should be linked to the new taxonomy (Action 1). This confirms what has been suggested in the relevant amendments of the new CRR/CRD legislative proposals by the members of the European Parliament (MEPs). The interaction, on the one hand, on finalising the legal text of CRR/CRD during the trilogues between MEPs, the Council and the EC, and, the other hand, finalising the taxonomy in time, will be a challenge.

Regarding insurance, the EC will request EIOPA for an opinion on the impact of ESG risks and sustainable assets on prudential rules for insurers, to be considered in the report to Council and EP by 1 January 2021. It should be noted that this report, where appropriate, should be accompanied by proposals to adapt the Level 1 legislation or Level 2 standards (Solvency II, Art. 111(3)). This brings the timing to 2023 at the earliest before any change will be applicable, if any.

- ❑ **Action 10** calls on fostering sustainable corporate governance and attenuating short-termism in capital markets. ESAs are invited to collect evidence of undue short-term pressure from capital markets on companies, whereby ESMA should especially look for portfolio and equity holding periods and other practices that result in short term pressure on the economy.

It is peculiar that the EC doesn't mention the pending delegated act for packaged retail investment and insurance-based investment products (PRIIPs), to be adopted pursuant to Article 8 (4) of the PRIIPs Regulation<sup>23</sup> on key information documents (KID). Article 8 (4) regards the procedures used to establish whether a PRIIP targets specific environmental or social objectives. Nor does the EC mention PRIIPs Article 33, which requires the EC to assess the feasibility, costs and possible benefits of introducing a label for social and environmental investment by 31 December 2018.

Regarding pension funds, the report falls short of suggesting further actions beyond IORP II, not even a reevaluation of the current ESG requirements in this Directive on occupational retirement funds. However, the planned legislative proposal on investor's duty is expected to impact institutions for occupational retirement provision (IORPs) and their asset managers as well, and will need to be implemented by pension funds (see next chapter).

## 5.2. A significant advisory role for ESAs in new legislative proposals on sustainable finance

In its Action Plan, the EC calls on the ESAs:

*"to provide direct support to its implementation by performing specific tasks [...]. Notably, the ESAs should provide guidance on how sustainability considerations can be effectively taken into account in relevant EU financial services legislation and help to identify existing gaps. They should also promote convergence on the implementation of sustainability considerations in EU law." "In the short term the ESAs should play an important role in identifying and reporting on the risks that sustainability factors pose to financial stability. This could be done through the development of a common EU methodology for relevant scenario analyses, which could later evolve into climate/environment stress testing."*<sup>24</sup>

The EC launched the first set of legislative proposals based on the APFSG on 24 May 2018. These proposals foresee a significant new advisory role to be played by the ESAs.

- ❑ The **first** legislative proposal is a Regulation to establish a framework within which a categorisation of 'sustainable investment' will be facilitated.<sup>25</sup> It sets out the conditions and the

<sup>23</sup> Regulation (EU) No. 1286/2014 on key information documents (KID) for PRIIPs, called 'PRIIPs' in short.

<sup>24</sup> EC, Action Plan on Financing Sustainable Growth, 8 March 2018, p. 12.

<sup>25</sup> EC, Proposal for a Regulation on the establishment of a framework to facilitate sustainable investment, COM (2018) 353 final - 2018/0178 (COD), 24 May 2018, [https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance\\_en#investment](https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en#investment) (viewed 24 May 2018). This proposal intends to implement Action 1 of the APFSG.

criteria to gradually create a unified classification system ('taxonomy') on, as a priority, what can be considered as substantially contributing and not substantially harming climate mitigating and climate adaptation, and other environmentally sustainable economic activities (related to water, waste, pollution and ecosystems). Advice on how to set up this taxonomy will come from a technical working group (see Action 1 of the APFSG). The ESAs will be member of the Platform on Sustainable Finance (to be created in 2019), which will advise the EC on technical requirements for the development of the taxonomy, including a social sustainability taxonomy in a much later phase, and the impact it has.

The EC describes the tasks of the ESAs related to the taxonomy as follows:

*“The ESAs will play a key role in the development of EU taxonomies to ensure that they are usable by financial institutions, applicable to financial products and compatible with the EU financial legislation, including prudential regulation. For example, EBA and EIOPA will ensure that EU taxonomies can allow the analysis of risk differences between bank and insurance assets/exposures and will analyse such differences and their possible incorporation into prudential regulation. ESMA and EIOPA will contribute to the incorporation of EU taxonomies into the rules under which investment companies [and] pension funds are managed. ESMA and EBA in particular will ensure that EU taxonomies can feed into the development of green bond standards and other financial products green labels and contribute to the development of such standards and labels. ESMA will also ensure that EU taxonomies feed into the construction/analysis of sustainability benchmarks and will contribute to linking EU taxonomies with suitability assessments of financial instruments and with corporate reporting.*

*The ESAs, in particular EBA and EIOPA, will have an important role to play in ensuring that taxonomies are developed in such a way that they are useable for climate scenario analysis and, at a later stage, for climate stress testing, and will contribute to the development of methodologies for such scenario analysis and stress testing based on EU taxonomies. The ESAs, in particular ESMA, will contribute to the collection and analysis of market data (including transactional data) for the Sustainable Finance Observatory.”<sup>26</sup>*

- The **second** EC legislative [proposal is a Regulation that will introduce disclosure obligations](#) on the different kind of institutional investors, asset managers and investment advisors on how they integrate sustainability risks in their investment decisions (and the related remuneration) and what impact this has, so as to increase transparency thereof.<sup>27</sup> The proposal requires to amend the sectoral legislations of the different kind of investors and asset managers in order to integrate the obligation (omnibus legislation). For products with sustainability claims, the information disclosure reporting requirements are more stringent. The regulatory technical standards that will provide the details of the disclosure obligations will be drafted by the EBA, EIOPA and ESMA, together through the ESAs Joint Committee. The draft standards are to be submitted to the EC which will adopt them according to established processes. This means that all ESAs have a significant advisory role to ensure an effective implementation of this regulation. National supervisors will have to supervise the implementation of the disclosure requirements.

The proposed Regulation itself includes the introduction of delegated acts by the EC which will require institutions for occupational retirement provision (IORPs) to integrate ESG risks and ESG factors in investment decision-making processes, as part of their duties towards end-investors and beneficiaries. In technical terms, the EC (Art. 10 of the proposed Regulation) would like to amend Article 19 of IORP II so that the EC is empowered to adopt delegated acts that ensure

<sup>26</sup> Ibidem, p. 37-38.

<sup>27</sup> EC, Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, COM (2018) 354 final - 2018/0179 (COD), 24 May 2018, [https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance\\_en#risks](https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en#risks) (viewed 24 May 2018). This proposal intends to implement Action 7 of the APFSG.

that the 'prudent person' rule takes account of ESG risks, and that ESG factors are included in the internal investment decisions and risk management processes.<sup>28</sup> This proposed Art. 10 means that not all institutional investors and asset managers will be subject to that duty directly through Level 1 legislation as was envisaged to Action 7 of the APFSG. This Art. 10 of the Regulation also refers to the legislations for some other investors, which require e.g. how to apply the prudent person principle 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). National supervisors and EIOPA will have a role in monitoring the implementation by IORPs and other investors once delegated acts are in place (no date is mentioned but the EC wants to have the IORP II delegating ready at the same time that the transparency Regulation will have to be fully applied).

- ❑ The **third** proposed [regulation will amend the benchmark regulation](#).<sup>29</sup> It regulates the minimum requirements and disclosure obligations for issuing 'low-carbon benchmarks' and a 'positive carbon impact benchmarks' in order to provide investors with better information on the carbon footprint of their investments, which can prevent 'green washing'. While national supervisors have a primary role in registering, authorising and monitoring the implementation of the benchmark legislation and its proposed amendments, ESMA is to be involved in cross border and third country issues and promoting common supervision.<sup>30</sup>
- ❑ **Finally**, the EC issued a consultation on [amendments to delegated acts under MiFID](#)<sup>31</sup> and the [amendments to delegated acts under the IDD](#)<sup>32</sup> to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients (see above, Action 4 of the APFSG).

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<sup>28</sup> See [https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-354\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-354_en).

<sup>29</sup> EC, Proposal for a Regulation amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks, 24 May 2018, [https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance\\_en#benchmarks](https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en#benchmarks) (viewed 24 May 2018).

<sup>30</sup> See: Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014, 8 June 2016, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1011&from=EN> (viewed 24 May 2018).

<sup>31</sup> EC, Commission delegated regulation (EU) .../... of XXX amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, [Draft for consultation from 24 May 2018 onwards], [https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2681500\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2681500_en) (viewed 24 May 2018).

<sup>32</sup> EC, Commission delegated regulation (EU) .../... amending Delegated Regulation (EU) 2017/2359 with regard to environmental, social and governance preferences in the distribution of insurance-based investment products, [Draft for consultation], [https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2681527\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2681527_en) (viewed 24 May 2018).

## 6. Is ESG supervision at national level already possible?

The intentions of the HLEG and the EC as expressed in 2018 to integrate sustainability or ESG risks and factors had not been considered earlier when drafting legislation, apart from IORP II in December 2016, even though civil society<sup>33</sup> had already called on to do so during the financial reform legislative process. Possibilities to include ESG into day-to-day national supervision were thus not known before or even not intended.

### 6.1. Banks' risk assessment

The reason why ESG factors should be considered a part of the obligatory risk assessment by banks is that assessments of credit risks (the probability of re-payment by borrowers) must include the potential impact of changing environmental and social circumstances, e.g. due to climate risks on the debtor (or investee) and on the value of the collateral of a loan. Market risk (changes in market prices) may result from a crack-down on a borrowing firm's aggressive tax evasion policies (a governance issue). The supervisors and central bankers of the Network for Greening the Financial System require their banks to show them how they include ESG in their credit and market risk assessments. Other supervisors don't follow this practice yet, but may do so if legislation is explicit that credit risk and market risk include ESG impact on creditworthiness and market value.

The HLEG recommended, among others, to update the supervisors' single rulebook, i.e. revising EU sectoral Level 1 laws that define what are the scope and legal mandates of the supervisors, taking into account that supervision is currently still mainly at national level and for the systemic banks, by the ECB supported by national supervisors. For banks, the single rulebook concerns capital requirements in the CRR and CRD IV<sup>34</sup>, and the supplementing regulatory technical standards (RTS).

Today, that single rulebook for banks does not explicitly include ESG supervision. However, this rulebook is being legally reviewed in Spring 2018 by the European Parliament and the Council (see chapter 6).

The capital requirements specified in the CRR should reflect the full risk spectrum on which the required adequate capital buffer should be based. However, the current requirements for the "internal capital adequacy assessment process" (ICAAP) do not include environmental or social risks. During the CRR and CRD IV review in Spring 2018, members of the EP have suggested amendments to include ESG in risk assessments (see chapter 6). The governance requirements specified in CRD IV focus on fit-and-proper tests of banks' boards, structures and remuneration. They do currently not include environmental and social considerations, e.g. whether the board members are aware of climate risks to the bank's assets and loan collateral. The "supervisory review and evaluation process" (SREP) by national supervisors or the ECB could thus include in the future additional requirements regarding ESG, in Article 97 CRD IV amongst others, so that supervisors have the competence to ask board members whether they are acquainted with ESG risks.

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<sup>33</sup> See for instance: Why to integrate Sustainability criteria in financial regulation?, March 2011, <https://www.somo.nl/wp-content/uploads/2011/03/Sustainability-criteria-in-banking-rules-1.pdf> (viewed 10 May 2018); Seven steps to make banks sustainable, March 2011 (updated from 2010) <https://www.somo.nl/wp-content/uploads/2011/07/Seven-steps-to-make-banks-sustainable-in-2011.pdf> (viewed 10 May 2018); M. Vander Stichele, The Missing Dimension - How European Financial Reforms Ignore Developing Countries and Sustainability, October 2011, <https://www.somo.nl/wp-content/uploads/2011/11/The-Missing-Dimension.pdf> (viewed 10 May 2018).

<sup>34</sup> CRR/CRD: Capital Requirements Regulation (575/2013/EU) (CRR), and CRD IV Capital Requirements Directive (2013/36/EU) (CRD IV).

## 6.2. Insurers and reinsurers: Solvency II

Today, ESG supervision is not explicitly included in the single rulebook, i.e. the [Directive for insurers or reinsurers](#) (Solvency II), which also includes the supervisory mandate. Nevertheless, insurers that are supervised by the supervisors of the Network for Greening the Financial System are expected to include at least climate risk in their assessment of underwriting risk. In order to apply this broader assessment of underwriting risk and market risk to all insurers, Solvency II Level 1 legal provisions must be clarified accordingly, so that all national competent insurance authorities have the same clear mandate to supervise these risks, including from an ESG perspective

The current capital requirement rules specified in Solvency II do not reflect ESG risks to which insurers might be subject to, whether they are material or not, as this was not the objective of Solvency II. Rules on insurer's governance focus on fit-and-proper tests for the members individually and collectively of boards, management bodies, internal supervisory bodies, and key function holders (related to risk management, actuarial, compliance and internal audit). Investments need to be made according to the prudent person principle (PPP). However, there is no explicit requirement to consider ESG factors, unlike for occupational pension funds (as in IORP II, Articles 19 and 21). Solvency II requires insurers, both those using the standard formula as well as those using a partial or full internal model for assessing risks, to conduct an "own risk and solvency assessment" (ORSA). In this ORSA exercise, insurers need to take into account their specific risk profile. This implies identifying and assessing the risks faced both in the short and long term (Solvency II, Art. 45). Thus, the ORSA requires a comprehensive approach to the identification and measurement of risks, via qualitative and/or quantitative assessments. While at least the following risks are considered: underwriting risk, market risk, credit risk and operational risk (Solvency II, Art. 101), ESG risks assessments are not part of ORSA requirements, as is the case for market risks for occupational pension funds (IORP II, Art. 25). In order to properly, but, at the same time, proportionately consider ESG risks in the risk profile, insurers would have to re-examine their portfolio and each of their risks from an ESG perspective, which today is a strategic decision of the insurers themselves.

The HLEG's final report referred to the insurers' ORSA requirement to undertake a comprehensive approach to the identification and measurement of risks, via qualitative and/or quantitative assessments.<sup>35</sup> The HLEG is of the opinion that under Solvency II, insurers for which climate risk is material should already be taking this into account, and the supervisory review should explicitly cover climate risks and risk mitigation. This may be a challenge, as the ORSA provisions requires that if (and only if) the assumptions underlying the calculation of the solvency capital requirement via the standard formula or internal model do not significantly reflect all risks covered in that solvency capital requirement, the insurer must mention that the risk profile deviates from the assumptions (Solvency II, Art. 45). Article 45(7) further explains that the ORSA shall not serve to determine a capital requirement. The Level 3 ORSA guidelines that give guidance to the Level 1 directive, state (in paragraph 1.13.) that the insurer should develop its own processes for the ORSA, with appropriate and adequate techniques, tailored to fit into its organisational structure and risk-management system, and taking into consideration the nature, scale and complexity of the risks inherent to the business. This could be understood as including ESG risk, but there is no clear evidence where this was interpreted this way. ORSA guideline paragraph 1.16. adds that an insurer's ORSA policy should specify how and how often stress tests, sensitivity analyses, reverse stress tests or other relevant analyses are to be performed. This could be understood as testing climate scenarios as well, and some insurers may indeed do so. ORSA guideline paragraph 1.19. states that the insurer should provide a quantification of the capital needs and a description of other means needed to address all material risks, irrespective of whether the risks are quantifiable or not.

Lastly, guidelines paragraph 1.20. adds that where appropriate, the insurer should subject the identified material risks to a sufficiently wide range of stress tests or scenario analyses in order to provide an

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<sup>35</sup> HLEG, Financing a sustainable European economy – Final Report, 31 January 2018, p. 70.

adequate basis for the assessment of the overall solvency needs. This could be understood as including material ESG risks. However, Level 3 guidelines cannot be enforced legally unless translated into national law. In order to guarantee EU-wide application and EU wide enforcement, the obligation to include ESG risks in the supervisory review would need to be included in the Level 1 text, and the scope, tasks and functions of EIOPA should be adapted accordingly (see chapter 6).

Article 37 of Solvency II doesn't give national supervisors a mandate to interfere either, as, unlike for the banks' SREP, an additional capital requirement by national supervisors in the EU may only be applied in exceptional circumstances, i.e. a failure in the governance system of an insurer in line with the requirements of Solvency II, or the risk profile significantly deviates from the assumptions underlying the Solvency Capital Requirement (SCR). This exceptional measure applied in practice to about 20 in 4000 insurers and to 4 insurance groups, all related to SCR coverage issues, in 2016.

### 6.3. Pension funds: a start of ESG considerations

Regarding pension funds, thus far, the issues of sustainability reporting and integration of ESG risks and ESG factors by EU pension funds in their investment decisions, its risk management and its governance have been taken up in the areas of occupational pension funds, namely in the 2016 update to the Directive on the Activities and Supervision of the Institutions for Occupational Retirement Provision (IORP II, Art. 19, 21, 25, 28, 41; see also below chapter 6.1). The consideration of ESG impact was included as follows:

- ❑ Clear references that risk assessment of the investment portfolio includes assessment from an ESG point of view,
- ❑ the prudent person principle (PPP) that incorporates ESG factors, and
- ❑ the governance of investment decisions that need to consider ESG.

The 2017 proposal on [Pan-European Personal Pensions Products \(PEPP\)](#)<sup>36</sup> for voluntary private personal pension funds provides in a similar limited way to take ESG risks into account (Pillar 3). More provisions could be included to ensure that ESG risks, sustainability factors and preferences are taken into account.

Both IORP II and PEPP encourage pension providers to disclose publicly whether and how they account for climate risk, and include such factors in their risk management systems. This means that pension supervisors have already some tasks regarding ESG issues and need to build the capacity to do so.

### 6.4. MiFID, PRIIPs & IDD: existing investment legislation

Investment firms are not bound to include ESG in either information or advice to (potential) investors nor in their asset management. Although the Markets in Financial Instruments Directive ([MiFID II](#))<sup>37</sup> was meant for investor protection, ESG considerations did not make it to the legal provisions. Article 25 of MiFID II on investors' suitability and appropriateness to decide on an investment, requires the investor's advisor to make an assessment of the investor's individual risk tolerance and investment objectives. Article 56 of the supplementing delegated regulation (a Level 2 technical standard), elaborates upon this concept by underlining that the advisor should understand the investor's risk tolerance, and that the investor should understand the transaction's risks, but there is no legal provision mentioning to assess and advise on the longer-term impact and/or ESG impact in which the investor might be interested in.

An exception about informing investors are the specific provisions for complex 'packaged' retail investment funds and insurance products (PRIIPs) that are aimed at investing in environmental or social (EOS) causes. The marketing of such funds are not only subject to the regular provisions of the [PRIIPs](#)

<sup>36</sup> EC, Proposal for a Regulation on a pan-European Personal Pension Product (PEPP), COM/2017/0343 final - 2017/0143 (COD), 29 June 2018, <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017PC0343&from=EN> (viewed 10 May 2018).

<sup>37</sup> Directive 2014/65/EU, May 2014.

Regulation on key information documents (KID)<sup>38</sup>, but to additional investor information rules regarding the EOS impact of the fund. However, investors who do not ask for EOS funds will not have been informed about the EOS impact of their standard investment, and, as such, cannot make an informed decision about the sustainability impact of their investment. This is a missed opportunity for advising about the environmental and social impact of funds in general, and advising on EOS funds in particular.

Regarding the [Insurance Distribution Directive \(IDD\)](#)<sup>39</sup>, there are no references to ESG considerations in IDD, except one reference to the Charter of Fundamental Rights (preamble consideration (71)). In order to remediate this situation, the HLEG<sup>40</sup> suggests that asset managers should have a sound understanding of their clients' interests and preferences, including ESG factors. For their institutional clients (such as insurance undertakings or pension funds), asset managers should be consistent with the long term obligations towards the members and beneficiaries of these institutional clients. Furthermore, asset managers should provide clear information to their clients about the potential benefits and risks, including the effect on the prospective return of the strategy of the investment. This information is important for insurance intermediaries and insurance undertakings under IDD, as distributors are bound under IDD obligations to regard the appropriateness and suitability of products to their customers.

As there is no mentioning of ESG considerations in the IDD, there is also no mentioning of ESG considerations in the two delegated acts of 21 September 2017, based on IDD.<sup>41</sup>

- ❑ [Delegated Regulation \(EU\) 2017/2358 on product oversight and governance requirements for insurance undertakings and insurance distributors](#) details that only products compatible with the needs, characteristics and objectives of the customers in the target market are to be designed and brought to the market (for example, Art. 5: *"Manufacturers shall only design and market insurance products that are compatible with the needs, characteristics and objectives of the customers belonging to the target market."*) This Delegated Act applies to all insurance products.
- ❑ [Delegated Regulation \(EU\) 2017/2359 on information requirements and conduct of business rules applicable to the distribution of insurance-based investment products](#) explains in Article 9 which information is to be obtained to assess the suitability for the customer, including, for example, the purpose of the investment. No explicit mention of ESG checks are included in the needs assessment.

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<sup>38</sup> Regulation (EU) No 1286/2014.

<sup>39</sup> Directive (EU) 2016/97, January 2016.

<sup>40</sup> HLEG, Final Report, January 2018, p. 23.

<sup>41</sup> It should be noted that the IDD's transposition and application has been very recently postponed. In addition, the delegated acts on product oversight and governance requirements for insurance companies and insurance distributors, and on information requirements and other rules applicable to the distribution of insurance-based investment products, normally applicable as of 23 February 2018, are also being postponed, in order to align the application dates of the two IDD Delegated Regulations, to 1 October 2018.

## 7. How to integrate ESG supervision in today's legislation

Not all supervisors and central banks, unlike those of the Network for Greening the Financial System, are already convinced that their duty to safeguard financial stability and consumer protection includes monitoring climate risk and ESG risks. Some national and European supervisors regard climate, or other ESG impacts, as unrelated to their mandate, and would prefer explicit assignments to consider ESG impact as an integral part of safeguarding financial stability.

### 7.1. Using the current mandates and legislation

In IORP II, a solution was found to incorporate the consideration of ESG impact in Articles 19, 21, 25, 28, 41. Technically, the crucial legally enforceable provisions are in Articles 19, 21 and 25, as follows:

- ❑ Article 19 on investment rules requires Member States to allow IORPs to take into account the potential long-term impact of investment decisions on ESG factors as part of the PPP.
- ❑ Article 21 on the general governance requirements requires Member States to require all IORPs to have in place an effective system of governance which shall include consideration of ESG factors related to investment assets in investment decisions, and which shall be subject to regular internal review.
- ❑ Article 25 requires that the risk-management system shall also explicitly cover ESG risks as a separate risk relating to the investment portfolio and the management thereof.

These legal references do not change the fundamentals of prudential supervision, but they do change the supervisory approach to enforcing the rules.

**Supervision should thus focus on the risk assessment process of e.g. finance contracts, as well as the monitoring process of those contracts' enforcement. ESG supervision will only be effective if it is integrated into 'what is', the basic concepts of credit risk, market risk and underwriting risk, and to a lesser extent, operational risk, because those are the fundamental concepts that guide the current regulatory and supervisory framework for assessing regulated entities' soundness.** Beyond assessing the expected financial outcomes of the exposures, these supervisory processes should also assess the environmental, social and governance impact on those outcomes and on the financial soundness of the financial institutions, their financial sustainability, and ultimately, what this means for the protection of their customers beyond pure financial returns. This is how financial institutions can steer sustainable finance decisions and guide investees towards sustainable decisions. By expanding the current assessed spectrum of risks, the uncertainty of non-payment and value-depreciation is mitigated.

As the Network of 'willing' supervisors shows, the key to success appears to be concrete steps towards sustainable risk assessments, embedded in a published supervisory mission statement that announces the integration of sustainability into supervisory assessments. In addition, options to scale up green and sustainable financing can be explored<sup>42</sup>.

New supervisory practices can happen, for example, by asking all supervised entities that accept commercial real estate as collateral for loans whether they know the energy label distribution of their portfolio, and the potential impact on the collateral value. In The Netherlands, it appeared that for loans

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<sup>42</sup> Charter of the Central Banks and Supervisors Network for Greening System (NGFS), [https://www.banque-france.fr/sites/default/files/ngfs\\_charter\\_20180424\\_0.pdf](https://www.banque-france.fr/sites/default/files/ngfs_charter_20180424_0.pdf) and [https://www.banque-france.fr/sites/default/files/medias/documents/press-release\\_2018-05-29\\_publication\\_of\\_the\\_mandates\\_of\\_the\\_ngfs\\_technical\\_workstreams.pdf](https://www.banque-france.fr/sites/default/files/medias/documents/press-release_2018-05-29_publication_of_the_mandates_of_the_ngfs_technical_workstreams.pdf) (viewed 30 May 2018).

to commercial real estate companies, banks know what the energy label distribution is for roughly 50% of those loans. Of those loans where they were aware of the label distribution, 46% of bank loans to commercial real estate companies in relation to offices were found to have an energy label lower than C. This is important to know, since from 2020 Dutch law will require new government buildings to have a C-label or higher, and all government buildings will have to have an energy label of C or higher by 2023. The known part of the real estate portfolio with a label lower than C is regarded to be approximately 6 billion Euro worth of loans. Banks responded swiftly to this outcome and are reconsidering acceptance processes for real estate as collateral. This is possible within current mandates and prudential legislation, in this particular case, Pillar 2 checks of collateral assessments. Other small steps would regard sustainable development goal-related impact relevant for the region or market of a particular group of regulated entities. Supported by clear and published mission statements, and annual accountability publications by the supervisory authorities, integrating ESG into their day-to-day work would follow naturally.

Although most supervisory responsibility is left with the national supervisors, coordination and European supervision is left with the ESAs. Within their current mandates, the ESAs can already apply their existing powers that are not related to prudential assessments, but aimed at collecting and sharing information among national supervisors, fostering convergence of practices by national supervisors, inspired by best practices, and publishing opinions for national supervisors and legislators, based on their reviews of the ESG impact of and on the financial industry, provided they commit to an interpretation of their mandate that includes the ESG perspective.

## 7.2. What legislative reference do supervisors need?

In order to effectively supervise ESG impact by all supervisors of, and on, actors in the financial sector, explicit references need to be developed and established in Level 1 sectoral legislation to clarify the national supervisory mandate to that extent, which relates to what ESAs need to do, as explained above.

Changes in sectoral legislation to strengthen national ESG supervision can follow IORP's example. IORP II, preamble consideration (57) states:

*"It is essential that IORPs improve their risk management while taking into account the aim of having an equitable spread of risks and benefits between generations in occupational retirement provision, so that potential vulnerabilities in relation to the sustainability of pension schemes can be properly understood and discussed with the relevant competent authorities. IORPs should, as part of their risk management system, produce a risk assessment for their activities relating to pensions. That risk assessment should also be made available to the competent authorities and should, where relevant, include, inter alia, risks related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ('stranded assets')."*

IORP preamble consideration (58) adds:

*"Environmental, social and governance factors, as referred to in the United Nations-supported Principles for Responsible Investment<sup>[43]</sup>, are important for the investment policy and risk management systems of IORPs. Member States should require IORPs to explicitly disclose where such factors are considered in investment decisions and how they form part of their risk management system. The relevance and materiality of environmental, social and governance factors to a scheme's investments and how such factors are taken into account should be part of the information provided by an IORP under this Directive."*

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<sup>43</sup> PRI, What are the Principles for Responsible Investment?, <https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment> (viewed 25 May 2018).

These arguments are followed up by the EC's second legislative proposal of 24 May 2018 (see chapter 4.2.) by which it wants to strengthen Article 19 of IORP II to ensure that ESG risks are taken into account in the prudent person principle and ESG factors included in the internal investment decisions and risk management processes.

Also, following suggestions of the HLEG and the APFSG plans, the consultations launched on 24 May 2018 by the EC (see chapter 4.2.) aims to ensure that under MiFID and IDD, investment firms and insurance distributors ask about their clients' preferences (such as environmental, social and governance factors) and take them into account when assessing the range of financial instruments and insurance products to be recommended, i.e. in the product selection process and suitability assessment. The EC proposes to amend the IDD-delegated acts so as to consider ESG factors, the implementation of which will need to be supervised.

Effective supervision of the whole of the financial sector will take place by testing whether and how sustainability policies are applied in investees', underwritten events' and debtors' assessment and monitoring.

The explicit reference that some supervisors need in order to integrate ESG into their assessment of regulated entities' soundness can easily be included in the respective legislative frameworks without changing their fundamental outline. This mainly, but not exclusively, regards:

- ❑ supervision for banks in pillar 2 (CRD: ICAAP and SREP): banks' conditions for applying internal ratings-based approaches (IRBA) should be reviewed for including the ESG perspective on credit risk, and the "standardised approach" may benefit from general ESG principle applying to all exposures,
- ❑ supervision for insurers and re-insurers (Solvency II, ORSA) and IDD,
- ❑ supervision for pension funds (IORP II: PPP and own risk assessment), and future PEPPs, and
- ❑ asset manager requirements for investment funds (MiFID II, AIFMD<sup>44</sup>, UCITS<sup>45</sup>).

Concrete amendments on how to insert concrete references are proposed in:

- ❑ **Annex I** for banks,
- ❑ **Annex II** for insurers and re-insurers,
- ❑ **Annex III** for investment advice.

### 7.3. International coordination

Effective ESG supervision is, per definition, a cross-border international exercise. Social impact (especially labour & human rights), governance impact (especially tax evasion & avoidance) and environmental impact (especially climate-related impact) is no longer confined to national borders. The UN SDGs can guide the collection of information on impact as well as on best practices, and as such, support supervisory coordination.

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<sup>44</sup> Alternative Investment Fund Managers Directive: Directive 2011/61/EU on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 8 June 2011, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&from=EN> (viewed 10 May 2018).

<sup>45</sup> Undertakings for Collective Investment in Transferable Securities Directive II: 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depository functions, remuneration policies and sanctions, 13 July 2009, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0091&from=EN> (viewed 10 May 2018).

To avoid the impact of stricter supervision resulting in financial activities travelling to less supervised countries, not only must ESG supervision must be coordinated among the supervisors within the European Union and by the ESAs, international coordination in the G20 bodies, such as FSB, BCBS, IAIS, IOSCO and OECD, would be better. The ESAs can take such coordination initiatives according to their mandate (respective Article 33 in each of the laws establishing the ESAs).

The Network for Greening the Financial System was initiated as a group of central banks and supervisors that wished to share their practices and improve them step by step. Central banks and supervisory authorities can only join if they contribute to the improvement and integration of climate risk supervision. The group is not bound to any existing international body, which implies that the group can work flexibly. Once good practices are established, each of the members can share these in existing international bodies to inspire revisions of the current regulatory and supervisory frameworks.

## 8. Conclusion

Both the HLEG on Sustainable Finance and the EC wish for ESG risk assessments and sustainability considerations to be integrated by supervised entities and by supervisors. In order to include ESG factors in day-to-day supervision, with a task for the ESAs to ensure this done effectively cross-border, amendments to the EC's ESA review proposals will be needed to strengthen ESG supervision. In addition, in order to integrate such new ESG requirements explicitly and unambiguously for the ESAs and for all of the supervised financial actors and their national supervisors, the sectoral legislative frameworks will equally need to be amended. Such reviews can be implemented through the EC's Action Plan on Financing Sustainable Growth and its implementing legislative proposals, as well as the legislative reviews of existing EU legislation, such as that for banks (CRR/CRD) being discussed in Spring 2018.

# ANNEX I

## Amendments that strengthen ESG supervision of banks' capital requirements (CRR, CRD)

Following the international framework from the Basel Committee on Banking Supervision, EU bank legislation is built on three pillars:

- calculated total risk exposure amounts (TREA) and capital requirements accordingly in **Pillar 1**,
- the internal assessment of capital adequacy by banks (ICAAP), including governance processes, and the review and evaluation thereof by supervisors (SREP) in **Pillar 2**, and
- disclosure requirements aimed at market discipline following information about the institution in **Pillar 3**.

Since the capital requirements are calibrated applying a one-year time horizon, risks that materialise after one year are not integrated into Pillar 1 calculations.<sup>46</sup>

Although the EC did not include ESG in its CRR/CRD IV review proposals<sup>47</sup>, several members of the European Parliament suggested amendments to have banks and their supervisors integrate ESG considerations when assessing, monitoring and controlling the risks of their exposures. The supervisors who are part of the Network for Greening the Financial System already include climate-related considerations when assessing the credit and market risk estimates by banks. For the other supervisors, an explicit assignment to include ESG in that assessment could be carried out through the amendments of CRR/CRD as suggested hereafter.

In **CRR's** Pillar 1, this regards suggestions to include a risk differential for "green" (i.e. climate/environmentally sustainable) exposures versus "brown" (i.e. climate/environmentally unsustainable) exposures, and delegating the EC to define the difference based on EBA advice. The suggestions all regard so-called corrections to Pillar 1, included, inter alia, in Article 501. Alternatively, a general provision in the credit risk title could be included, for example in a **new Article 110a** as drafted below. This new general provision would imply a general correction of the standardised approach in cases in which an institution does not know the amount of greenhouse-gas carbon emissions it finances, and a general condition for internal models in the internal ratings-based approach.

"Article 110a

### **Adjustment for climate impact**

- 1. Institutions shall apply the provisions in this Title to exposures without a negative greenhouse-gas impact. Where an exposure has a negative greenhouse-gas impact, or where the greenhouse-gas impact is not known to the institution, institutions shall multiply the applicable risk weight with a factor [1,1 in 2019; 1,2 in 2020; 1,25 in 2021].*
- 2. EBA shall develop draft regulatory technical standards to specify the calculation of the greenhouse-gas impact for each of the exposure classes and types of exposures identified in this Title. EBA shall submit those draft regulatory standards to the Commission by [two years after entry into force]."*

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<sup>46</sup> The EC proposed in November 2016, in co-decision in Spring 2018, to apply a longer term approach to infrastructure that serves a public need in a new Article 501a CRR.

<sup>47</sup> EC, Proposal to amend Directive 2013/36/EU on banking prudential requirements, 23 November 2016), <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0854&from=EN> (viewed 25 May 2018); EC, Proposal to amend Regulation (EU) No 575/2013 on banking prudential requirements, 23 November 2016), <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0850&from=EN> (viewed 25 May 2018).

Moreover, stress testing must at least include climate-related scenarios, which must be explicit in the Level 1 provisions for Pillar 1, e.g. in **Article 325bj (1) CRR**:

*“(g) the institution shall frequently conduct a rigorous programme of stress testing, including reverse stress tests, **and including at least climate-related scenarios**, which shall encompass any internal risk-measurement model. The results of these stress tests shall be reviewed by senior management on at least a monthly basis and comply with the policies and limits approved by the institution's management body. (...)”*

In Pillar 2, the discretionary dialogue between banks and their supervisors allows the integration of ESG risks into overall assessments, as well as appropriate measures by supervisors to steer individual banks in a more sustainable direction.

Also for Pillar 2, some members of Parliament proposed integrating ESG in both the ICAAP and the SREP in a **new Article 84a CRD (ICAAP)** and a new letter in the SREP's risk types list in **Article 98(1) CRD**:

; *“Article 84a*

#### ***Material ESG-related risks***

1. *The competent authorities shall ensure that policies and processes for the identification, measurement and management of all material sources and effects of material ESG-specific risks are implemented.*

2. *For the purposes of paragraph 1, the institution shall identify the following:*

- a) *the risks to which the institution is exposed in the short, medium and long terms;*
- b) *significant concentrations of credit exposures involving carbon-related assets, and other environmental or social related assets, if these exposures are material;*
- c) *the impact of the material ESG-related risks on the institution's business, strategy and financial planning, if these risks are material and financial;*
- d) *the processes which the institution uses to identify, assess and manage material ESG-related risks;*
- e) *the parameters which the institution used to assess the impact of short-, medium- and long-term material ESG-related risks on lending and financial intermediary transactions, if these risks are material.*

3. *The EBA shall issue guidelines to specify:*

- a) *what is meant by short-term, medium-term and long-term;*
- b) *what is meant by specific material ESG-related problems which may arise in the short, medium or long term and which could have a material, financial impact on the institution;*
- c) *what is meant by physical risks and transition risks;*
- d) *what is meant by the processes used to determine which risks could have a material, financial impact on the institution;*
- e) *what is meant by a carbon-related asset, consistently with an EU brown taxonomy adopted with the same process as for the EU green taxonomy.*

*The EBA shall publish these guidelines by ... [two years after the entry into force of this Directive].*

4. *To assess climate-related risks of institutions, the EBA should pilot forward-looking climate scenario analysis on their portfolios, in coordination with relevant ESAs and national competent authorities.”*

Members of European Parliament also propose to add ESG risks to the list of risks to be assessed by supervisors in the **SREP in Article 98 CRD**:

*“the assessment of the integration of environmental, social and governance (ESG) risks in the institution's risk-management system;”*

For Pillar 3, disclosure requirements are in principle related to Pillar 1 requirements, but remuneration was added as a Pillar 2 element in the disclosure provisions, so some members of the European Parliament suggested a new Article 448a or 449a CRR such as the following. The amendment is, however, confusing, as it interferes with the recently adopted Non-Financial Disclosure Regulation and the Non-Financial Reporting Directive. A more effective amendment would have been to impose these new laws on non-listed banks as well. Moreover, a text only becomes legally enforceable after publication in the Official Journal, which implies that the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD, sponsored by the Financial Stability Board) should also be published in the Official Journal. Since the fundamental principles of effective disclosure are buried in appendix 3 of the TCFD recommendations, it's questionable whether this amendment will make the compromise text.

“Article 449a

**Disclosure of the ESG-related risks in annual report**

*1. From... [3 years after entry into force of this Regulation], institutions disclose the following information on material Environmental, Social and Governance (ESG)-related risks in accordance with Article 84a of Directive 2013/36/EU and, for climate-related risks, in accordance with the recommendations of the Task Force on Climate-related Financial Disclosure:*

- a) A description of the specific problems relating to material ESG risks, which could arise in the short, medium, or long-term and could have a material or financial impact on the institution, and whether these are physical or transition risks;*
- b) A description of the processes that are used to determine which risks could have a material or financial impact on the institution and how these are integrated into the overall risk management;*
- c) A description of significant concentrations of credit exposures against carbon-related assets, if these are material;*
- d) A description of the impact of material ESG-related risks on the business, strategy and financial planning of the institution, if these are material;*
- e) A description of the processes that the institution uses to identify, evaluate and manage risks;*
- f) The parameters that the institution used to evaluate the impact of short-, medium- and long-term climate-related risks on finance, if these are material;*
- g) A description of the role of the management body with regard to the evaluation and management of climate-related risks.”*

## ANNEX II

### Amendments that strengthen ESG supervision of insurers' and re-insurers' (Solvency II)

As is the case for banks, some national supervisors don't need additional legal provisions to include ESG risk in their assessment of insurers' and re-insurers' best estimates of underwriting risk and market risk. Other supervisors do need this explicit reference, which could be given as suggested below. At least those ESG provisions could be included that were agreed upon in IORP II, which agreement could serve as a minimum for amending Solvency II. In addition, it should be made explicit that ESG risk considerations should be part of insurers' and re-insurers' estimates of their most important risk concepts: underwriting risk, market risk and credit risk. As such, formulae can stay as they are, while input for those formulae will have to encompass more perspectives than what is required today. Enriching the definitions of the basic concepts (see changes to Article 13) also implies that throughout the legislative framework, ESG needs to be included in risk assessments and estimates.

#### Article 13

##### **Definitions**

(30) 'underwriting risk' means the risk of loss or of adverse change in the value of insurance liabilities, due to inadequate pricing and provisioning assumptions, **including assumptions of environmental, social and governance impact on the liabilities;**

(31) 'market risk' means the risk of loss or of adverse change in the financial situation resulting, directly or indirectly, from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments, **including fluctuations as a consequence of environmental, social and governance impact;**

(32) 'credit risk' means the risk of loss or of adverse change in the financial situation, resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which insurance and reinsurance undertakings are exposed, in the form of counterparty default risk, or spread risk, or market risk concentrations, **including fluctuations as a consequence of environmental, social and governance impact;**

[...]

**(41) Environmental, social and governance factors means factors as referred to in the United Nations-supported Principles for Responsible Investment [copied from IORP II]**

#### Article 27

##### **Main objective of supervision**

Member States shall ensure that the supervisory authorities are provided with the necessary means, and have the relevant expertise, capacity, and mandate to achieve the main objective of supervision, namely the protection of policy holders and beneficiaries **in a sustainable way.**

## Article 36

### **Supervisory review process**

4. The supervisory authorities shall assess the adequacy of the methods and practices of the insurance and reinsurance undertakings designed to identify possible events or future changes in economic, **environmental or social** conditions that could have adverse effects on the overall financial standing of the undertaking concerned.

## Article 41 [See IORP II, Art. 21]

### **General governance requirements**

1. Member States shall require all insurance and reinsurance undertakings to have in place an effective system of governance which provides for sound and prudent management of the business. That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. **The system of governance shall include consideration of environmental, social and governance factors especially related to investment assets in investment decisions.** The supervisory authorities shall assess the ability of the undertakings to withstand those possible events or future changes in economic conditions.

[...]

5. The supervisory authorities shall have appropriate means, methods and powers for verifying the system of governance of the insurance and reinsurance undertakings and for evaluating emerging risks, **including from ESG factors**, identified by those undertakings which may affect their financial soundness.

## Article 44 [See IORP II, Art. 25]

### **Risk management**

[...]

2. The risk-management system shall cover the risks to be included in the calculation of the Solvency Capital Requirement as set out in Article 101(4) as well as the risks which are not or not fully included in the calculation thereof.

The risk-management system shall cover at least the following areas:

(a) underwriting and reserving;

(b) asset–liability management;

(c) investment, in particular derivatives and similar commitments;

(d) liquidity and concentration risk management;

(e) operational risk management;

(f) reinsurance and other risk-mitigation techniques.

**(g) ESG risks relating to the investment portfolio and the management thereof, if not included in the areas listed in (a)-(f).**

The written policy on risk management referred to in Article 41(3) shall comprise policies relating to points (a) to (f) **(g)** of the second subparagraph of this paragraph.

Article 45 [See IORP II, Art. 28]

### **Own risk and solvency assessment**

1. As part of its risk-management system every insurance undertaking and reinsurance undertaking shall conduct its own risk and solvency assessment.

That assessment shall include at least the following:

(a) the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking, **including a qualitative assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change (stranded assets);**

[...]

### **Public disclosure**

Article 51 [See IORP II, Art. 30]

### **Report on solvency and financial condition: contents**

1. Member States shall, taking into account the information required in paragraph 3 and the principles set out in paragraph 4 of Article 35, require insurance and reinsurance undertakings to disclose publicly, on an annual basis, a report on their solvency and financial condition.

That report shall contain the following information, either in full or by way of references to equivalent information, both in nature and scope, disclosed publicly under other legal or regulatory requirements:

[...]

(c) a description, separately for each category of risk, of the risk exposure, concentration, mitigation and sensitivity; **this description shall contain, at least, how the investment policy takes environmental, social and governance factors into account.**

Article 132 [See IORP II, Art. 19(1)(b) ]

### **Prudent person principle**

1. Member States shall ensure that insurance and reinsurance undertakings invest all their assets in accordance with the prudent person principle, as specified in paragraphs 1a, 2, 3 and 4.

**1a. Within the prudent person rule, Member States shall allow insurance and reinsurance undertakings to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors.**

### **Life insurance**

Article 185 [See IORP II, Art. 41]

### **Information for policy holders**

1. Before the life insurance contract is concluded, at least the information set out in paragraphs 2 to 4 shall be communicated to the policy holder.

2. The following information about the life insurance undertaking shall be communicated

[...]

**(n) information on whether and how environmental, climate, social and corporate governance factors are considered in the investment approach, and where further information is available**

**(o) fiduciary duty requirements. In addition, specific information shall be supplied in order to provide a proper understanding of the risks underlying the contract that are assumed by the policy holder.**

Article 244

### **Supervision of risk concentration**

[...]

2. Member States shall require insurance and reinsurance undertakings or insurance holding companies or mixed financial holding companies to report on a regular basis and at least annually to the group supervisor any significant risk concentration at the level of the group, **including those related to ESG factors**, unless Article 215(2) applies.

## ANNEX III

### Amendments of MiFID II & IDD to strengthen ESG supervision of investment

MiFID II, Article 25 regarding investor suitability is already today openly formulated with respect to how the suitability of the investment product is tested. This implies that supervisors can choose to require suitability to be tested including ESG considerations and investors' ESG preferences, depending on the translation of this requirement in their national legislation. ESMA could include the ESG perspective in its updated guidelines in Q4 2018.

An explicit Level 1 reference with respect to suitability testing could be as follows in **Article 25 MiFID II**:

*"2. When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and his investment objectives including his risk tolerance, **including environmental, social and governance risk**, so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance, **including ESG risk**, and ability to bear losses. Member States shall ensure that where an investment firm provides investment advice recommending a package of services or products bundled pursuant to Article 24(11), the overall bundled package is suitable."*

In the **IDD**, a similar reference can be made in **Article 30**:

*Article 30*

#### **Assessment of suitability and appropriateness and reporting to customers**

*"1. Without prejudice to Article 20(1), when providing advice on an insurance-based investment product, the insurance intermediary or insurance undertaking shall also obtain the necessary information regarding the customer's or potential customer's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including that person's ability to bear losses, and that person's investment objectives, including that person's risk tolerance, **including environmental, social and governance risk**, so as to enable the insurance intermediary or the insurance undertaking to recommend to the customer or potential customer the insurance-based investment products that are suitable for that person and that, in particular, are in accordance with that person's risk tolerance **including ESG risk**, and ability to bear losses. Member States shall ensure that where an insurance intermediary or insurance undertaking provides investment advice recommending a package of services or products bundled pursuant to Article 24, the overall bundled package is suitable."*

*"5. The insurance intermediary or insurance undertaking shall provide the customer with adequate reports on the service provided on a durable medium. Those reports shall include periodic communications to customers, taking into account the type and the complexity of insurance-based investment products involved and the nature of the service provided to the customer and shall include, where applicable, the costs associated with the transactions and services undertaken on behalf of the customer."*

*When providing advice on an insurance-based investment product, the insurance intermediary or the insurance undertaking shall, prior to the conclusion of the contract, provide the customer with a suitability statement on a durable medium specifying the advice given and how that advice meets the preferences, objectives and other characteristics of the customer, **including ESG risk tolerance**. The conditions set out in Article 23(1) to (4) shall apply.”*

## Glossary

APFSG: Action Plan on Financing Sustainable Growth  
CMU: the EU's Capital Markets Union  
CRR/CRD: Capital Requirement Regulation / Capital Requirement Directive  
EBA: the European Banking Authority  
EC: European Commission  
ECB: the European Central Bank  
EIOPA: the European Insurance and Occupational Pensions Authority  
ESAs: the European Supervisory Authorities  
ESG: environmental, social and governance (see 8.1.)  
ESMA: the European Securities and Markets Authority  
ESRB: The European Systemic Risk Board  
FSB: Financial Stability Board  
HLEG: High Level Expert Group on Sustainable Finance  
ICAAP: internal capital adequacy assessment process of a bank  
IDD: Insurance Distribution Directive  
KID: key information documents for investors  
IORP II: Directive on the Activities and Supervision of the Institutions for Occupational Retirement Provision  
MiFID II: Markets in Financial Instruments Directive  
'Level 1 legislation': EU law in the form of a Directive or a Regulation  
'Level 2': regulatory technical standards, implementing technical standards or delegated acts to implement Level 1 legislation  
PEPP: Pan-European Personal Pensions Products  
PPP: prudent person principle  
ORSA: own risk and solvency assessment by insurers  
PRIIPs: (Regulation) (on Key Information Documents for) Packaged [complex] Retail and Insurance-Based Investment Products  
RTS: regulatory technical standards  
Solvency II: Directive on the taking-up and pursuit of the business of Insurance and Reinsurance  
SREP: supervisory review and evaluation process of a bank  
Taxonomy: EU classification system of Environmental (, Social and Governance) sustainable activities  
UCITS: Undertakings for Collective Investment in Transferable Securities Directive

# Explanation of ESG

In this paper, we assume the following meaning of words commonly used in the sustainable finance debate.

**Sustainable:** meeting the needs of today without affecting the ability of future generations to meet their needs (according to the Brundtland Report)

**Environmental considerations** of finance imply the impact that finance will have on nature and natural resources;

positive environmental impact is usually achieved with financing organic farming, circular business models, biodiversity, renewable energy, clean water preservation, or natural resources preservation; negative environmental impact is regarded to be caused by a.o. animal testing, factory farming, unsustainable fisheries, and fur and specialty leather, fossil fuel, nuclear power, deforestation, genetic engineering, hazardous substances, unsustainable mining, contamination, and water-waste.

**Social considerations** of finance imply the impact of finance on people's well-being;

positive social impact is usually achieved by respecting human rights, human dignity, inclusion, respect and justice, a.o. by taking care of health, safety, and education;

negative social impact is regarded to be caused by finance that causes or facilitates a.o. violating human rights and labour rights, or irresponsible alcohol sales, gambling, pornography, tobacco, weapons, and conflict minerals;

**Governance considerations** of finance imply the impact of finance on fair and transparent ownership and management, and corporates' accountability;

positive governance impact is regarded to be achieved by a.o. transparent accounting, fair tax-policies, and fair remuneration;

negative governance impact is regarded to be caused by corruption, evasive tax-structures, and violation of legislation.

