Principles for Responsible Investment

EU SUSTAINABLE FINANCE: WHERE NEXT?

Sustainability – and sustainable finance – are key political priorities for the European Union. The EU's Green Deal aims to transform the European economy, including through reforming to financial services policy.

Globally, PRI recognises a shift in thinking from financial policymakers and regulators. Sustainable finance policy is becoming more comprehensive, more technical, and is increasingly seeking to link financial policy to changes in the real economy. The EU is seeking to lead this charge.

The PRI's policy team actively engages in support of progressive policy reform in Brussels and at EU Member State level. This briefing is part of a project to engage PRI signatories around the next phase of policy reform. The PRI is currently interviewing PRI signatories to understand the opportunities and the key priorities for the coming 5-year mandate and will issue a report with our findings in early 2020.

HOW TO GET INVOLVED

We welcome comments on this briefing from PRI Signatories and appreciate their availability for an interview. The interview questions can be online. Please contact:

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- Susanne Draeger, Senior Policy Analyst.

PROGRESS TO DATE

THE GLOBAL PICTURE

Over the past five years, PRI has observed a dramatic increase in the attention paid by financial policymakers to sustainability issues. Accompanying, and in some markets, leading this change, institutional investors have actively engaged with these policymakers on sustainability issues[1].

Capital investments required to achieve sustainability objectives are considered too significant to be borne by public budgets alone. Combined with the possibility that these investments can in many cases offer attractive investment returns, policymakers and investors increasingly recognise that private finance must play a role. This is reflected in the two most significant international agreements, namely the Sustainable Development Goals and the Paris Agreement on Climate Change, both of which explicitly recognise the critical role of private finance in delivering their goals. Forums such as the G20 discuss sustainable finance and have sought to introduce and incentivize private investment in projects that are aligned with sustainability objectives.[2]

PRI monitors global sustainable finance policy developments[3]. In recent years, we have observed a shift in focus. Sustainable finance policy and regulation is becoming more detailed and technical (for example, moving from principles-based risk management approaches to stress-testing and scenario analysis) and more outcomes-focussed, recognising that decisions made in the financial sector have real-economy impacts, whether intentional or not.

EU DEVELOPMENTS

Following international developments, under the 2014-2019 European Commission mandate, sustainable finance has emerged as a significant pillar in the EU's sustainability commitments. In 2016, the Commission has established a High-level expert group on sustainable finance which recommendations have laid the foundation for EU Action Plan on Financing Sustainable Growth adopted by the European Commission in March 2018. Since then, PRI has observed rapid developments in legislation and technical expertise related to sustainable finance (see timeline).

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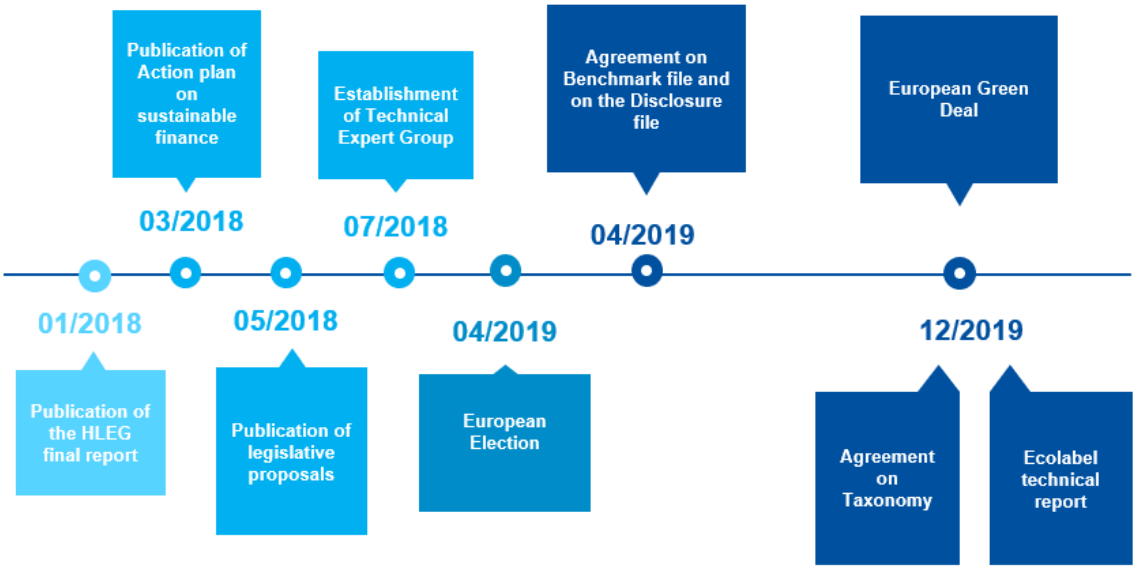
[1] *Taking Stock: Sustainable Finance Policy Influence and Engagement (PRI, 2019).*

[2] *Sustainable Finance Synthesis Report, (G20, 2018)*

[3] *https://www.unpri.org/sustainable-markets/regulation-map*



The EU Action Plan on Financing Sustainable Growth, launched in 2018, identified ten priority actions. Below, we summarise progress to date:

Action	Progress
Sustainability Taxonomy	The Taxonomy is a list of economic activities that make a substantial contribution to one or more environmental objectives, while avoiding significant harm to other environmental objectives. The regulation that establishes the Taxonomy was agreed in December 2019, while technical development of criteria continues, with a final report from a Technical Expert Group due in early 2020. Under the new regulation, investors marketing funds as sustainable are required to disclose the extent to which they have used the taxonomy and the % of the product invested in taxonomy-eligible activities. Corporates will also be required to disclose against the Taxonomy.
Standards and labels	The Technical Expert Group has made final recommendations for a voluntary EU Green Bond Standard which would directly link to the EU Taxonomy. Work is underway on creating an eco-label for financial products, with a final technical report setting out criteria due in 2020. The proposed criteria will refer to the EU Taxonomy.
Fostering investment in sustainable projects	The High-Level Expert Group concluded that project development capacity, at a national or sub-national level, was acting as a bottleneck and limiting the supply of sustainable infrastructure investment opportunities. To date, the EU has undertaken mapping of investment gaps.

Incorporating sustainability when providing financial advice	The European Commission has issued draft amendments to the delegated acts under MiFID II and the Insurance Distribution Directive which would create requirement to consider a client's sustainability preferences as part of the suitability assessment. Final details are expected in early 2020.
Developing sustainability benchmarks	The EU has established minimum standards for two new voluntary categories of benchmark products – climate transition benchmarks and Paris-aligned benchmarks. In December 2019, the Technical Expert Group on Sustainable Finance (TEG) published a Handbook on Climate Benchmarks and benchmarks' ESG disclosures.
Better integrating sustainability in ratings and market research	Credit Rating Agencies: the European Securities and Markets Authority, which directly regulates CRAs in Europe, has encouraged transparency from CRAs but stopped short of mandating CRAs to consider sustainability factors in their methodologies. Data providers: The EU has appointed a consultancy to undertake research into the sustainability data provider market with a view to identifying if action is required.
Clarifying institutional investors' and asset managers' duties	The European Commission is currently drafting amendments to the delegated acts underpinning the major financial services directives (MiFID II, UCITS, AIFMD, Solvency II) to clarify that sustainability risks should be considered as part of governance, risk management and disclosure. The Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, approved April 2019, will require investors to disclose details of their policy on integration of sustainability risks into investment decision-making both at a firm and product level. It also requires investors to disclose details of their approach to the principal adverse sustainability impacts of their investment approach or provide a clear explanation for why they do not consider such impacts.
Incorporating sustainability in prudential requirements	The Investment Firm Review, which examined prudential requirements for investors, resulted in a new requirement for greater disclosure of ESG risk. The EU has committed to further research on the integration of ESG risk in investment firms, and in the potential to establish "green" and "brown" factors in banks' capital requirements.
Strengthen sustainability disclosure and accounting rule-making	The Non-Financial Reporting Directive (2014) requires large European companies to issue a non-financial statement setting out information relating to environmental, employee, social, human rights and anti-corruption matters. The EU also issued non-binding guidelines which were updated in 2019 to reflect the disclosures recommended by the Taskforce on Climate-Related Disclosures.

Fostering sustainable corporate governance and attenuating short-termism in capital markets	The European Supervisory Authorities have released the results of a call for evidence on short-termism. Key recommendations include substantial reform of EU corporate sustainability reporting rules.

In addition to the above actions, the EU has also:

- **Established an International Platform on Sustainable Finance (IPSF)** alongside the governments of Argentina, Canada, Chile, China, India, Kenya and Morocco. The IPSF will strengthen cooperation and coordination on topics like taxonomies, disclosures, standards and labels, with a view to aiding private investors to identify environmentally sustainable investment opportunities.
- **Given European Supervisors a clear mandate on sustainable finance.** EIOPA, ESMA and EBA now have a specific mandate to monitor the development of sustainable finance and consider ESG factors in their work.

This is in addition to considerable developments at Member State level, such as the development of the French Energy Transition Law.

THE NEXT FIVE YEARS: THE EUROPEAN GREEN DEAL

The European Green Deal is one of the critical political priorities over the next European Commission mandate (2019 – 2024). The European Green Deal is a set of high-level goals which will be translated into tangible policy over the coming years and will impact wide range of policy areas across the economy, from transportation and agriculture to trade and climate diplomacy. Of particular relevance to investors, it will consider reforms in the areas of financial, tax, corporate governance and climate policy.

Key commitments include:

- Creation of a ***Sustainable Europe Investment Plan***. This will combine public finance and reforms to improve the flow of private finance, including technical assistance to develop the pipeline of investable green projects;
- Creation of a ***Just Transition Fund*** to minimise the impact of the transition to a climate-neutral economy on affected communities;
- A renewed ***Sustainable Finance Strategy*** in Autumn 2020 to create new measures to direct private capital to green and sustainable investments;
- Launch of legislative process to fully implement the **EU Taxonomy** and reflect on its applicability to the public sector;
- A significant review of ***corporate reporting***. The EC will review the Non-Financial Reporting Directive in 2020. Recent recommendations from the European Securities and Markets Authority (ESMA) recommend that the EU create mandatory metrics under NFRD and work to promote international convergence around ESG reporting;
- Sustainability will be further embedded into the ***corporate governance*** framework;
- Further integration of ***climate and environmental risks into the financial system*** through integrating these risks into the prudential framework and assessing the suitability of the

existing capital requirements for green assets. Further work will be done on increasing the contribution of the financial system to climate resilience; and

- The European Investment Bank EIB will transition to becoming ***Europe's climate bank***, doubling its investment in activities that combat climate change by 2025. This follows a recent decision by the EIB to stop financing fossil fuel energy generation from 2021.

The next Parliament and Commission mandate (2019-2024) will be a critical time to accelerate and mainstream sustainable finance. The EU will actively seek new initiatives and/or policy levers to help achieve the goals of the European Green Deal.