ipk european strategy

Challenges to the European Union's sustainability goals in financial services

Introduction

Sustainability is a widely used term that broadly captures environmental and climate change concerns, social issues such as labor, civil and human rights, and governance standards in both corporate and governmental sphere. Sustainability standards therefore can be seen to hold far-reaching implications for the investment and broader financial sectors.

Politicians and policy makers have identified the financial sector as a means through which to implement policy objectives, such as lowering carbon emissions, meeting commitments to lower global temperature targets, and thereby encouraging responsible social and corporate culture.

In this article we consider the latest developments in the European Union (EU). We underline the potential for the development of an asset class, free from green washing, to support a greener real economy. However, we also see potential for emerging risks to established principles, such as existing fiduciary obligations of advisers, an un-level playing field between MiFID firms and UCITS and AIFMs, and scoping issues associated with various transparency requirements giving rise to risk of discouraging investments in a green finance sector. Ongoing and future work on taxonomy and a prudential regime also provide for opportunities and risks.

Coherent and harmonised

At the outset however we set out two high-level risks common to large scale and broad EU initiatives; cross-sector coherency and harmonization issues.

EU financial sector initiatives on environment, sustainability and governance (ESG) issues are important aspects of the broader agenda for sustainability in the EU. It is important these initiatives, individually and as a package, sit coherently with other aspects of the

EU's sustainability agenda, such as energy, infrastructure and development and transport policy.

Specific initiatives come under the EU's Sustainable Finance Action plan[1] (The Action plan) and flow from the EU's ratification of the 2016 Paris Agreement[2]. It is important that the EU guards against individual member state interests determining relative prioritisation and approach to implementation of specific initiatives that leads to a fragmented EU market. Differing standards have posed a significant obstacle to the development of the single market in financial services and inward investment.

In the EU the main initiatives under the Action Plan are straight forward, but as ever with legislative proposals the detail is more complex.

The core elements targeting the financial sector in the EU include:

- Delegated Acts under MiFID2[3] – clarifying the integration of ESG considerations into existing fiduciary obligations of investment advisers and insurance providers;
- ESMA Advice to the European Commission on the integration of sustainability in investment services and advice to MiFID firms and AIFMD and UCITS entities;
- The May 2018 Package[4], which include proposals on Taxonomy, Disclosure for investment and insurance providers, and benchmarking;

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[1] Action Plan: Financing Sustainable Growth, Brussels 8th March 2018. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en#commission-action-plan-on-sustainable-finance

[2] The Paris Agreement was formally ratified by the EU on 5th October 2016, and entered into force on 4th November 2016: https://unfccc.int/files/meetings/paris_nov_2015/application/pdf/paris_agreement_english_.pdf

[3] COMMISSION DELEGATED REGULATION (EU) …/... of XXX amending Delegated Regulation (EU) 2017/2359 with regard to environmental, social and governance preferences in the distribution of insurance-based investment products

[4] https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en#investment

- Policy discussions on the prudential framework under CRR/CRD and Solvency 2, including supervisory approaches; and
- Corporate accounting and reporting, currently under the Non-financial Reporting Regulation

Fiduciary obligations

The European Commission proposal on the extent to which ESG implications of investments need to be considered in suitability assessments when providing advice to retail clients are proposed under secondary legislation, known as Delegated Acts under the EU's legislative system. Although on the face of it a consideration for retail market participants, the requirements are relevant for wholesale markets due to the direct impact on institutional investors and their beneficiaries, the so called 'look through', and also the indirect knock on impact on wider market participants through which those institutional investors invest. This includes MiFID firms, as portfolio managers, and asset managers registered under AIFMD[5] and UCITS. ESMA has also published its mandated Advice to the Commission on the integration of ESG in investment decisions following consultations in relation to MiFID, AIFMD and UCITS. The Delegated Act under MiFID, ESMA's approach and the recently agreed Disclosure Regulation should be read together to understand the full implications for managers.

Suitability assessments under MiFID involve considering investors' understanding of and ability to bear potential losses associated with instruments. With this in mind firms advising on investments and taking decisions on behalf of investors should consider the overall objectives of the investment in order to discharge their fiduciary duty to act in the interests of their clients. It is important that requirements to give effect to policy preferences under ESG do not impinge upon or undermine this legal obligation. One issue that

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[5]Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 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
https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1557483603069&uri=CELEX:32011L0061

continues to arise is the extent to which preferences of investors and beneficiaries associated with investing in ESG may conflict with the overall objectives of investments.

The Commission under its Delegated Act took a broad view on the extent to which ESG considerations should be mandated in investment advice and the decision process. The investment manager is required to ask about the preferences of the investor, and so has to include specific questions in the suitability assessment itself. This could lead to a situation where the *preferences* of the client on ESG potentially conflict with the fiduciary *obligations* of the manager. That is to act in the best interests of the client by taking decisions that deliver the *objectives* of the investment mandate.

The Commission's view is helpful to the extent it is clear that advisers should consider investments against ESG preferences only after considerations have been made against investment objectives under its mandate. It remains a question however if this effectively prioritises *objectives* over ESG *preferences*. ESMA appears to have not taken a further position on this issue in its Advice.

One way of gauging legislators' view on the overall impact of regulatory requirements, for instance costs that outweigh perceived benefits, is to consider any exemptions or waivers granted to participants from the new obligations. The European Parliament in this instance considered that pension funds should be exempt from the scope of the requirements, indicating the legislators appreciate there is a likely cost, potentially through impact on returns.

Pension funds have however come under pressure from activist law firms in the UK in relation to their obligation to consider environmental and sustainability impacts in their investment decisions. Pension funds have argued the only relevant considerations, under the fiduciary obligation, are those that are material to maximizing returns. The Department for Work and Pensions clarified in its response in 2017[6] to a Law Commission

[6] Pension funds and social investment: the government's interim response The government's interim response to the Law Commission report: Pension Funds and Social Investment (Law Comm No 374) December 2017

Report on the issue that environment and sustainability are among factors to be considered "financially material". This appears to be a matter for the Trustees of funds to determine when exercising their investment decision-making powers.

ESMA Technical Advice

ESMA has published advice to the Commission on the integration of ESG risks in investment decisions under MIFID[7], UCITS and AIFMD[8]. ESMA maintains its emphasis on proportionality and also the importance of taking a principles based approach, as set out in its consultation of December. However, there is a distinction in ESMA's approach with regard to the potential scope of the application of requirements.

Under MiFID organizational requirements provisions, firms are obliged to take into account ESG considerations *where relevant* for investment services to clients. A similar consideration is to be made when considering the application of the target market considerations under product governance requirements.

Meanwhile, ESMA proposes Member States ensure that AIFM firms *shall* take into account sustainability risks in respect of organizational structures, and notably senior management *is* responsible for the integration of sustainability risks. A similar approach is taken in its advice on UCITS and investment advice. ESMA was notably silent in its Advice on respondent concerns about consistency in the content of advice and in the use of similar terms and concepts between UCITS and AIFMD and for those proposed for

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[7] ESMA's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II
https://www.esma.europa.eu/sites/default/files/library/esma35-43-1737_final_report_on_integrating_sustainability_risks_and_factors_in_the_mifid_ii.pdf

[8] ESMA's technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD
file:///Users/ifthikharpkhan/Downloads/esma34-45-688_final_report_on_integrating_sustainability_risks_and_factors_in_the_ucits_directive_and_the_aifmd.pdf

MiFID. The differing approach from MiFID firms as well as the obligation itself is likely to cause concern for AIFMD and UCITS firms.

Disclosure requirements also run through the suite of legislative and technical measures being adopted in the EU. The substantive Disclosure legislation under the May 2018[9] package has been agreed and adopted. It aims to harmonize the transparency regime on the role and integration of sustainability in investment decisions and advisory process for investment and insurance-based investment products. It also sets out a new transparency regime for green investment products.

The scope of the legislation goes beyond environmental objectives and includes a broader range of risks associated with ESG. The broader disclosure regime for all investment services and advisory activity follows a traditional approach under financial services regulation; specifically documenting processes and maintaining policies, a significant part of which should be published on firm websites, and pre-contractual disclosure to clients under existing AIFMD, UCITS and MiFID modality. Notably, detailed description of procedures and conditions associated with ESG where there is an impact on returns and the relationship between ESG outcomes and remuneration of staff are considered important aspects of the framework. These requirements were not discussed in great detail as the proposal moved swiftly through the legislative process. The language of the remuneration provisions in particular indicate that the requirements go beyond disclosure and lean towards the presumption of identifiable risks associated with ESG that firm policies should be in line with.

This adds further importance to ESMAs Advice on ESG integration in the decision making process and the Commission's perspective on the extent to which ESG considerations should be incorporated into investment decisions. It will also be important to follow the regulatory technical standards (RTS) the Commission will take advice on from ESMA in relation to pre-contractual disclosures under

[9] Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341

the Disclosure legislation, albeit the application of this aspect is limited to sustainable investments only.

Taxonomy

The so called Taxonomy proposal[10] is designed to help investors make informed decisions based on the extent to which an investment is environmentally sustainable. Uniform criteria are the basis for determining environmental sustainability of an *economic activity*, and in turn the status of financial investments in companies involved in such activity. The classification system envisaged is focused on only the environmental impact of the economic activity. It does not include sustainability and governance. Further, it does not consider and designate the sustainability status of specific companies, products and assets. Based on the classification of the activity and additional disclosure obligations on fund managers, investors should be able to make informed decisions.

The scope of the classification process under the Commission's original proposal is broad as it covers all economic activities that receive financial investments under a green label *and those that are marketed as having similar characteristics.* Although the proposal has not yet been agreed the discussions to date indicate a narrower scope including services associated with only those instruments labeled and marketed as green. Such an outcome would be a significant narrowing of the scope. However, the proposed legislation has not been finalised, and is in fact the only part of the package of three files proposed last May (2018) that has been pushed back for further discussions under the next European Parliament.

The outcome of these discussions are important because the classification and designation of environmental sustainability is the basis on which other important requirements for financial sector will be considered, including prudential requirements for banks and investment firms under CRR and insurance companies under Solvency 2.

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[10] Proposal for a regulation on the establishment of a framework to facilitate sustainable investment

A narrow scope is important from the perspective of disclosure obligations on asset managers. Asset managers and distributers and issuers of in-scope instruments, must disclose how and the extent to which investment instruments are environmentally sustainable under the criteria and screening process. This is expected to be a detailed disclosure process based on further detailed delegated acts from the Commission. The legislation sets out firms must in the least make it clear to investors the amount of holdings that are directed to companies carrying out economically sustainable activities, and the amount of the investment as a proportion of all economic activity of target companies.

Aside from the disclosure obligations for in-scope financial instruments, any narrowing of the scope to only green instruments, including green bonds, runs the risk of discouraging investments into such instruments. Not only is the compliance burden associated with in-scope investments expected to be increasingly complex, uncertain and demanding in terms of sheer volume, the information disclosed to investors is not expected to be comparable to non-scope investments. The overall benefits may become questionable. Despite these potentially significant shortcomings, the regime is however expected to prevent so called 'green washing' in the financial sector, a problem the sector has to overcome to take steps towards being accepted as a viable asset class.

Prudential implications

Risks associated with discouraging investment in the ESG sector can be mitigated by more acute regulatory intervention. Under the Action Plan, the Taxonomy work will have a direct bearing on prudential work streams.

Policy makers are considering the feasibility of including climate and environment related risks in risk management policies and calibration of capital requirements under CRR. This is set to feature as an important agenda item under the new Parliamentary term and new Commission. Solvency 2 is also to be reviewed with a focus in similar capital calibration in relation to climate change mitigation.

Meanwhile, governors of major central banks, including France[11] and UK[12], have been increasingly vocal and specific about the risks to banks and insurers, and the kinds of measures that may be necessary to monitor them. Stress tests have been identified as good way to monitor for individual firm and sector preparedness. However, ultimately, direct risks, such as costs associated with catastrophe and climate change related extreme weather events, and indirect risks, such as exposure to a counterparties exposed to risks through bank lending and stranded assets, may increase the cost of capital through the financial system, and impact asset managers and the clients and ultimately the real economy.

Policy makers within central banks and other policy institutions are considering credit, market, operational and legal risks posed by exposure of financial and banking sector risks. Environmental risks, such as air and water pollution, reduced biodiversity and deforestation, and also climate change related risks, such as physical or transition risks and extreme weather events have been identified as priority concerns. Ultimately all risks can be captured by traditional prudential regulation, the problem is such risks translate into an increased cost of capital.

Accounting and reporting

Existing requirements under the EU Non-financial Reporting Regulations[13] are to be further examined. An important part of the current requirements are ESG risks that are to be set out in a strategic report as part of wider corporate reporting obligations.

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[11] Open letter from the Governor of Bank of England Mark Carney, Governor of Banque de France François Villeroy de Galhau and Chair of the Network for Greening the Financial Services Frank Elderson: https://www.bankofengland.co.uk/news/2019/april/open-letter-on-climate-related-financial-risks

[12] https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/a-new-horizon-speech-by-mark-carney.pdf

[13] The implementation of the EU Directive in the UK is through amendment to the Companies Act 2006: http://www.legislation.gov.uk/uksi/2016/1245/pdfs/uksi_20161245_en.pdf

There is prospect of a hardening of the current flexible approach to reporting. In the UK the implementation and approach to reporting under the regime has come under scrutiny, specifically in relation to oil and gas sectors. Outcome of regulatory considerations on this issue is expected to have a bearing on the continued approach to flexibility.

The reporting obligations in this area are increasingly relevant for large listed financial firms, such as banks and insurance companies. However, in March 2019[14] ESMA wrote to the Commission indicating its view that the size of companies should not be the basis of scoping firms out. Although asset managers and securities firms are currently out of scope as a sector, the direction of travel appears to be a broader scope of application.

Going forward

The EU continues to make progress on its agenda on sustainability in financial services. There remain important aspects yet to be determined. Arguably during early stages the EU has made ground on the less difficult technical aspects, mainly transparency requirements and disclosures. It has however also created concerns for some parts of the market even in this early stage. Big issues remain open, such as the detail around some of those disclosure obligations, integration of sustainability in investment decisions and advice where fiduciary obligations exist, the issues around prudential framework for banks and investment firms and insurance companies.

The substantive scope of the regime will be one of the most important aspects of this work. Currently, although many requirements are applicable where firms are dealing with green-labeled products and instruments, in the detail requirements also bite on broader financial services. Associated with this is on-going work to effectively build proportionality into the framework. The recent discussion on proportionality in the banking sector

[14] LETTER TO EC - REVISION OF THE EUROPEAN COMMISSION'S NON-BINDING GUIDELINES ON NON-FINANCIAL REPORTING: https://www.esma.europa.eu/press-news/esma-news/esma-responds-ec-consultation-update-reporting-guidelines-reflect-climate

demonstrated how complex and political this could be. Criteria and factors for determining sustainability of economic activity under the Taxonomy file will be important in this respect. There is also a strong push from civil society groups and politicians to broaden the scope to the wider financial sector for more of the requirements, and in a way that has a more intrusive hand in the markets.

The general public position and interest in the EU, and also regulatory authorities and central banker perspectives, currently rest uneasily against the global dimension. The position of the US on environmental and climate change related policy makes convergence on sustainability in financial services challenging. Application of conduct policy, and potentially prudential requirements, on investments in entities and instruments registered in third country jurisdictions, is another layer of politics for regulators and politicians to overcome. The reach and impact of requirements are broad. Measuring risks associated with activities and exposures in such a contentious environment holds potentially volatile market risk.

The success of the Green movement across the EU, including what is widely considered to be political breakthrough in the UK, is expected to be a driver for pushing a more ambitious agenda. This is expected to have a bearing on existing and new policy initiatives. The prospects for success should however be weighed against broader prospects of a more fragmented Parliament and political arrangement delivering outcomes.

Within the EU, work on an environmental tax has, along with other issues not deliverable before the end of the Parliament, slowed and awaits direction from new political leaders. Political positioning by member states and undertakings by senior politicians are already beginning. Corporate and political views on the taxation of carbon intensive activities, prospect of a CO2 Tax, and also a growing agenda on transportation and sustainability, are polarized, and no where more so than the European Council. This is expected to feed into financial sector discussions in various ways, as arguments about the competitiveness of EU markets are set to become even more acute.

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