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EU SUSTAINABLE FINANCE ACTION PLAN – WHAT YOU NEED TO KNOW

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The European Commission recently unveiled its strategy for reforming the EU financial system to support its climate and sustainable development agenda.

Announced on 8 March, "*Action Plan: Financing Sustainable Growth*" builds on many of the recommendations of the EU High-Level Expert Group on Sustainable Finance published earlier this year. Notable features of the Action Plan include the establishment of a new EU classification system for sustainable activities, mandating sustainability considerations into the fiduciary duties of institutional investors and asset managers, and measures to improve corporate disclosure of non-financial and climate related information.

The Action Plan represents a significant step in the EU's effort to embed sustainability considerations into the financial system and contains a wide range of legislative and non-legislative measures. Certain of the recommendations are for imminent implementation in 2018 whilst more controversial proposals, such as potential amendments to capital requirements in the EU, are likely to be subject to fierce debate.

Key issues

- A "roadmap" for integrating sustainability into the EU financial system
- 10 action points affecting many aspects of finance in the EU
- Implementation will begin in 2018
- The establishment of a new EU taxonomy on sustainability will underpin many initiatives
- Some aspects, notably potential changes to capital requirements and fiduciary duty, may be controversial

Background

Climate change and sustainable development are key priorities for the EU. Many of the Commission's objectives for 2014 to 2020 centre around its energy and climate policy and, ultimately, fulfilling commitments to the UN 2030 Agenda for Sustainable Development and the Paris Agreement on climate change.

The Commission also recognises that there is a significant funding deficit if it is to meet these targets. It is estimated that an additional EUR177 billion a year of investment is required to achieve the EU's climate and energy goals by 2030. Most of this will need to be provided by the private sector.

To tackle these challenges, the Commission has set out three broad aims in the Action Plan:

- "reorienting capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;

- managing financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- fostering transparency and long-termism in financial and economic activity."

Ten steps to sustainability

More specifically, the plan contains ten "action points" detailing the Commission's intentions and a timetable for implementation up to Q3 2019. An overview of this timetable is set out at the end of this briefing.

Action 1: Establishing an EU classification system for sustainable activities

The Commission intends to establish a taxonomy to classify what activities can be considered "sustainable". This is seen by the Commission as the most important and urgent item of the Action Plan. The taxonomy will be embedded in EU law and provide a framework for many other features of the Action Plan. It will, for example, be used to specify which activities will qualify as "green" in the new EU green bond label discussed in more detail below.

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The taxonomy is expected to be detailed, contain screening criteria and metrics, and will be dynamic to reflect evolving policy objectives and market, environmental and technological objectives. The Commission will set up a technical expert group to provide a first taxonomy on climate mitigation activities by Q1 2019.

To those following debates in sustainable and green finance the establishment of a EU taxonomy will come as no surprise. Accusations of "greenwashing" (that is, the practice of portraying activities as more environmentally friendly than they actually are) are commonplace in the environmental sector and have been levelled against certain issuers in the green bond market (for more, see our briefing: "*Greening the Financial System: What does it mean to be green?*). Whilst organisations such as the Climate Bonds Initiative already maintain well-developed taxonomies, the clear hope is that formal guidance from the EU on what constitutes a sustainable investment will further facilitate market integrity and the flow of capital.

Action 2: Creating standards and labels for green financial products

The Commission also proposes to establish certain EU sustainable standards and labels with the aim of further protecting integrity and trust.

Notably, a report on the establishment of an EU green bond standard is expected by Q2 2019 along with an amendment to the Prospectus Regulation to specify the content of a prospectus for green bond issuances.

Although the Action Plan provides little detail on the EU green bond standard, it seems likely that the Commission will look to the recommendations of the EU High-Level Expert Group. We therefore expect the new green bond standard to be based heavily on the existing ICMA Green Bond Principles, albeit certain features, such as the need for external verification, may become mandatory.

Action 3: Fostering investment in sustainable projects

Recognising the significant contribution of infrastructure to greenhouse gas emissions, the Commission is looking to build on existing efforts to foster investment in the sector. In particular, it has come forward with the idea of a single EU investment fund for the post-2020 multiannual financial framework to provide financial support and technical assistance for investment in sustainable infrastructure. This builds on similar proposals from the EU High-Level Expert Group.

Action 4: Incorporating sustainability when providing financial advice

The Commission is also seeking to ensure that investor preferences on sustainability are taken into account when investment firms and insurance distributors provide financial advice.

According to the EU High-Level Expert Group on Sustainable Finance, there is strong evidence that European retail investors overwhelmingly believe that social and environmental objectives are important for their savings and investments and that these preferences (particularly prevalent in "millennial" investors) are not being adequately taken into account.

To address this, the Commission intends to amend both the MiFID II and the Insurance Distribution Directive delegated acts in Q2 2018 to ensure that regard is given to investors' sustainability preferences and subsequently ask ESMA to include provisions on sustainability preferences in its guidelines on the suitability assessment by the end of 2018.

Action 5: Sustainability Benchmarks

The Commission has two broad aims in relation to market benchmarks and indices – increasing transparency and comparability.

First, the Commission intends to use the Benchmark Regulation to increase the transparency of the methodologies that are used to create sustainability benchmarks. This is expected to happen in Q2 2018.

Second, an initiative for harmonising benchmarks made up of low-carbon issuers will be established with the express aim of ensuring they are aligned with the aims of the Paris Agreement. The Commission's technical expert group will publish a report on the design and methodology of these low-carbon benchmarks by Q2 2019.

Action 6: Better integrating sustainability in ratings and market research

Credit rating agencies also feature in the Action Plan. The Commission plans to engage stakeholders on the merits of amending the Credit Rating Agency Regulation to require credit rating agencies to explicitly incorporate sustainability factors into their credit assessments. Interestingly, the Commission has also included a reference to the emergence of new credit rating agencies with a view to meeting its sustainability objectives, although it does not provide further details.

In a related development, the Commission also recognises the increasing importance of sustainability metrics in helping investors make their investment decisions, and it commits to carry out a comprehensive study on sustainability metrics and research by Q2 2019.

Action 7: Clarifying institutional investors' and asset managers' duties.
The idea that sustainability considerations should be embedded in the "fiduciary" duties of institutional investors and asset managers is not new. For example, in 2005, the United National Environment Programme Finance Initiative produced a detailed paper on the integration of environmental, social and governance issues into institutional investment.

More recently, the interim recommendations of the EU High-Level Expert Group on Sustainable Finance published in July 2017 were instrumental in leading the Commission to launch a public consultation on institutional investors' and asset managers' duties regarding sustainability in November 2017.

The Commission now intends to table legislative proposals to clarify the role of sustainability considerations by Q2 2018. The aim will be to explicitly require institutional investors and asset managers to integrate sustainability factors and risks in their investment decision-making process and increase transparency towards end-investors on how they integrate those considerations.

These proposals would also be a natural extension of the requirements to be placed upon institutional occupational pension providers to consider environmental, social and governance issues in relation to their pension investment portfolios (under Directive 2016/2341, the so-called IORP II Directive, which Member States must implement by 13 January 2019).

Action 8: Incorporating sustainability in prudential requirements
Perhaps the most controversial item in the Commission's plans is the potential amendment to the EU's existing capital requirements for banks and insurance companies to "better reflect the risks associated with climate and other environmental factors". The clear intention is to investigate the notion that sustainable assets are by their nature better insulated against climate change and therefore inherently less risky.

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The Action Plan does not go as far as to say it intends to introduce a "green supporting" factor (that is, a reduction in capital requirements for certain sustainable lending activities) or "brown penalising" factor (a levy on environmentally damaging or unsustainable investments) but it does intend to explore the feasibility of including environmental risks in financial institutions' risk management policies and does not rule out potential amendments to the Capital Requirements Regulation and Directive.

Whilst Valdis Dombrovskis, vice-president of the Commission, has recently said that they are "looking positively" at the idea of green capital relief, the Commission has also stressed the need for any measures to be justified from a risk and financial stability perspective. It remains to be seen how this item in the Action Plan will play out.

Action 9: Strengthening sustainability disclosure and accounting rule making
Improving corporate disclosure of sustainability-related, and particularly climate-related, information is an increasingly hot topic. The "Task Force on Climate–related Financial Disclosures" (TCFD), a Financial Stability Board backed set of voluntary guidelines for incorporating climate related information into financial reports, is now supported by more than 240 companies globally. For more, see our briefing: "*Greening the Financial System: Institutionalising climate change – the Climate Task Force Recommendations*".

The central idea behind these initiatives is that improved sustainability disclosure enables investors and stakeholders to better assess companies' long-term value creation and sustainability risk exposure. There is also a measure of self-protection for reporting entities. Not only are NGOs taking an increasing interest in the robustness of corporate reporting on sustainability issues; we have also begun to see instances where companies are being investigated by regulatory authorities, or challenged in the courts, for failure to disclose information about climate change risks.

The Commission has made a number of recommendations in the Action Plan on the topic of disclosure, including a "fitness check" of EU legislation relating to public corporate reporting to ensure it contains adequate consideration of sustainability (including potential amendments to the Non-Financial Reporting Directive), and providing further guidance for companies on how to implement climate related disclosure in line with the TCFD. Adopting the TCFD as, effectively, best practice would be particularly significant for reporting companies given its emphasis on forward-looking analysis under different climate change scenarios.

Finally, the Commission is looking at ways to allow for specific adjustments to certain accounting standards where they are "not conducive to the European public good" citing, in particular, concerns about the negative impact of IFRS 9 on long-term investments.

Action 10: Fostering sustainable corporate governance and attenuating short-termism in the capital markets

The final element of the Action Plan is aimed at behavioural change. First, the Commission will carry out a range of consultative measures to assess the need for corporate boards to develop and maintain a sustainability strategy and the possible clarification of rules according to which the directors are expected to act in a company's long-term interest.

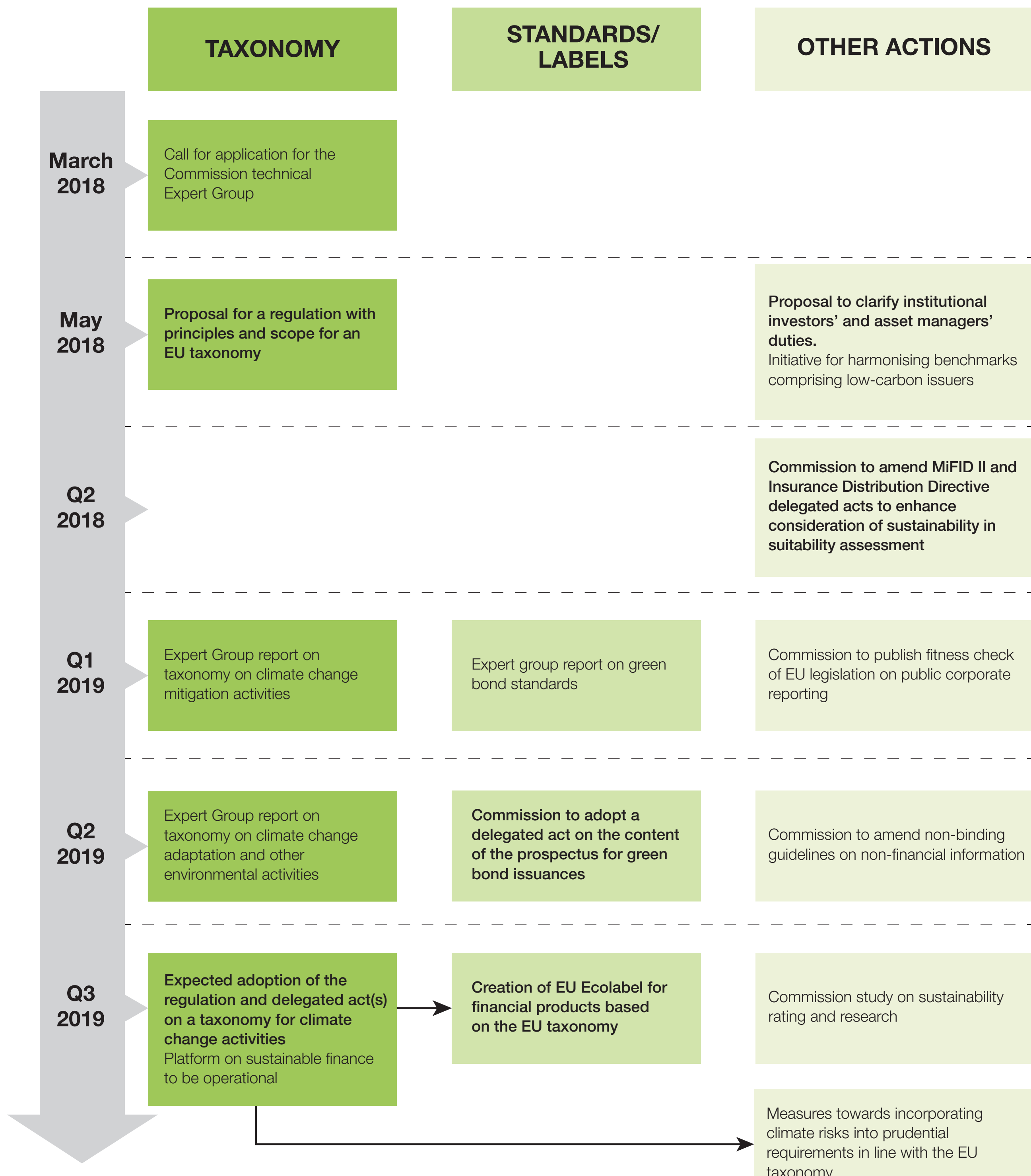
Second, the Commission will also investigate how it can help to "attenuate short-termism in the capital markets" by inviting the European Supervisory Authorities to collect evidence on factors that make it difficult to lengthen the time horizons in corporate decision making.

Of all the items in the Action Plan this appears to be the least concrete, and it will be interesting to see if any more practical proposals emanate from the Commission's initial recommendations.

The Action Plan is noteworthy for both the scope and practical nature of its recommendations. It is also clear that, for the Commission, implementation is a pressing matter and not something for deferral.

In our earlier briefing, "*Greening the Financial System: Making Sense of the Initiatives*" we outlined the growing trend for regulators to incorporate sustainable and green considerations into their policy making and the need for all actors in the financial system to take note. This is a prominent example of that trend.

Implementation Timeline



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