HUME BROPHY

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THE EU SUSTAINABLE FINANCE PROPOSALS

IMPACTING THE FINANCIAL INDUSTRY AND ITS CLIENTS!

2015 saw the adoption of several landmark international agreements including the Paris Agreement and the UN 2030 Agenda for Sustainable Development which contains 17 Sustainable Development Goals.

The One Planet Summit that took place in Paris in December 2017 aimed at mobilising public and private finance in support of climate action and created a broader political momentum around sustainable finance. The involvement of the private sector is important; investments well beyond the capacity of public institutions will be needed in areas such as the construction of energy efficient buildings or low-carbon transportation to meet the EU's environmental goals. In the climate and energy space alone, it is estimated that an additional annual investment of 180 billion euros is needed to meet the EU's climate and energy targets by 2030.

The US withdrawal from the Paris Agreement has given the European Union (EU) an opportunity to become a global leader in this field. Acknowledging the importance of the issue, the European Commission ('Commission') established a High-Level Expert Group on sustainable finance (HLEG) in December 2016, which delivered its key recommendations in January 2018 in its final report. Following up on the work of the HLEG, the Commission published in March 2018 its Action Plan on sustainable finance.

In line with the Action Plan, on the 24th of May, the Commission published a first package of legislative measures on sustainable finance impacting financial institutions. The sustainable finance agenda has the potential to have a direct and indirect impact on all sectors of the economy: agriculture, energy, manufacturing, transport and technology. In the long run, the ability of financial institutions – banks, institutional investors, fund managers – to fund certain economic activities could have a tremendous impact on the cost of capital and funding of every single company.

In this briefing we first examine the three legislative proposals published on the 24th of May and their potential loopholes. We then explore to what extent these proposals could have an impact on non-financial actors. To conclude, we observe what the possible next steps in the EU legislative process might be.

1 THE LEGISLATIVE PACKAGE AND ITS RELEVANCE FOR THE FINANCIAL INDUSTRY

The Commission's legislative package consists of three legislative proposals on sustainable finance: one creating an EU taxonomy for sustainable activities, one on disclosures relating to sustainable investments and sustainability risks and one developing sustainability benchmarks. Amendments to the delegated acts under MiFID II and IDD have also been issued on the same day to ensure that sustainability preferences are taken into account in the suitability assessment.

EU taxonomy for sustainable activities

The reorientation of capital flows towards assets that contribute to sustainable development requires a clear definition of what is sustainable and what is not. The Commission thus issued a proposal of regulation introducing a common concept of sustainable economic activity in the form of a 'taxonomy'. This taxonomy has been presented as the cornerstone of any future action of the Commission on sustainable finance, as it will set the standard for what is considered sustainable. Indeed, it was described as "the most important and urgent action" by the Action Plan and was also the first recommendation of the HLEG's final report.

Scope

This regulation will apply both to:

- **Standards and labels set at the Member State** and **EU level** for market actors and the offering of financial products or corporate bonds pursuing environmental objectives; and
- **Financial market participants** offering financial products as environmentally sustainable investments (e.g. SRI, ESG, impact investing). This includes fund managers (UCITS, AIFM, EuVECA and EuSEF), institutional investors (Solvency II insurers and IORP pension funds), insurance distributors (IDD) and investment advisors and asset managers (MiFID II).

Financial products in the scope of the taxonomy include MiFID authorised firms conducting portfolio management, AIFs, Insurance-Based Investment Products (IBIP), pension products, pension schemes or UCITS funds when these products are pursuing sustainable investments.

Core obligation – disclosing the share of investment holdings

Covered entities will have to disclose both the way in which, and the extent to which, criteria determining the environmental sustainability of an investment are taken into account in the investment decision-making processes. Over time, this will be completed with more detailed rules adopted by the Commission in a delegated act that will allows clients to identify:

- the percentage of holdings pertaining to companies carrying out environmentally sustainable economic activities; and
- the share of investment funding environmentally sustainable economic activities as a percentage of all economic activities.

Key concepts – environmentally sustainable economic activity, 'substantially contribute', 'no significant harm'

The structure of the taxonomy relies on three core concepts: environmentally sustainable economic activitites, 'substantial contributions', and the principle of 'no significant harm'.

The taxonomy will be activity based, rather than institutions based looking at a particular company (issuer) or asset. The taxonomy does not harmonise the methodology to determine the environmental sustainability of an investment in certain companies or assets. The uniform criteria however will allow to determine the degree of environmental sustainability of a given economic activity, for the purposes of investment.

In order to qualify as environmentally-sustainable economic activities would have to fulfil the following requirements:

- Contributing substantially to one or more of the environmental objectives set out in the regulation
- Causing no significant harm to any of these environmental objectives
- Being carried out in compliance with minimum safeguards
- Complying with technical screening criteria which will be specified in delegated acts

When establishing the technical screening criteria through delegated acts, the Commission will have to meet the following requirements:

- Take a quantitative and qualitative approach, using thresholds where possible
- Use scientific evidence and take the precautionary principle into account
- Build upon pre-existing standards and labels, setting out environmental sustainability criteria in other contexts, such as product labelling
- Take into account the impact on market liquidity and competition
- Avoid increases in stranded assets and mitigate the risk that certain assets lose value as a result of the transition to a more sustainable economy

EU environmental objectives to which economic activities will have to contribute to be considered environmentally sustainable:

OBJECTIVE	TIMELINE FOR THE DELEGATED ACTS DETERMINING THE TECHNICAL SCREENING CRITERIA FOR EACH OBJECTIVE
1 Climate change mitigation	Delegated act to enter into application on 1 July 2020
2 Climate change adaptation	Delegated act to enter into application on 1 July 2020
3 The sustainable use of, and protection of water and marine resources	Delegated act to enter into application on 31 December 2022
4 Transition to a circular economy, waste prevention and recycling	Delegated act to enter into application on 31 December 2021
5 Pollution prevention and control	Delegated act to enter into application on 31 December 2021
6 Protection of healthy ecosystems	Delegated act to enter into application on 31 December 2022

Eager to allow market participants to have more time to prepare for the application of the new rules, the operational part of the Regulation and the detailed taxonomy will not apply until 6 months after the adoption of each future delegated act by the Commission.

Key challenges?

While the proposal for a taxonomy is ambitious and is a cornerstone underpinning the EU's strategy to become a leader in sustainable finance, the proposal may face some headwinds and challenges.

First, the proposal may see some **institutional challenges** by the co-legislators – the Council and the European Parliament. The concrete content of the taxonomy, meaning the technical screening criteria, will only really be designed in the Delegated Acts which will be adopted over the next few years. In this procedure, co-legislators have much less influence in comparison to Level 1 legislation. Additionally, these delegated acts may end up containing criteria that have a significant impact on other fields such as energy, industrial, agriculture and transport activities. Some EU Member States are probably unlikely to agree to grant such potentially wide-ranging powers to the Commission.

Secondly, the **scope of the proposal currently only covers institutional investors**. However, the European economy currently remains heavily reliant on financing from bank lending, one of the core justifications for the Capital Markets Union initiative. In its current form, the taxonomy will have no bearing on bank lending activities across the EU. This is probably an area for further work by the Commission in the future.

Thirdly, the current proposal contains **no compliance and enforcement mechanism**. One of the key reasons for a taxonomy is the need to avoid **'Green Washing'** the practice of gaining an unfair competitive advantage by marketing a financial product as environment-friendly, when in fact it does not meet basic environmental standards. The proposal however does not contain any provisions related to compliance with the taxonomy, the authority in charge of supervising the compliance (the Commission, the European Supervisory Agencies or national regulators?) or any sanctions resulting from non-compliance with the taxonomy. The proposal also does not contain any requirement for the disclosure under the taxonomy to be 'audited' by a third-party.

The Commission will examine the need for a compliance and verification mechanism at the next stage in the review planned within 2 years of the entry into force.

Finally, there is an emerging discussion as to whether the current proposal provides favourable treatment to a particular kind of sustainable investment over the other. Through its focus on the real impact of economic activities, the taxonomy seems to be favouring the SRI impact-driven investing approach over the broad ESG approaches seeking merely to assess companies pursuant to ESG criteria. This may cause some additional risks to product providers currently offering only broad ESG strategies rather than SRI-style strategies. This risk should however remain limited as long as EU rules do not contain hard thresholds in terms of the type of investment that would be compliant with the EU taxonomy.

Fiduciary duty for institutional investors - disclosures relating to sustainable investments and sustainability risks

Existing EU legislation requires institutional investors, asset managers and advisers to act in accordance with the best interests and expectations of their clients and beneficiaries and in compliance with the mandate assigned to them, up to now it did not explicitly include any duty for them to consider sustainability factors and risks in the investment decision process. This proposal aims at **integrating ESG considerations into the investment and advisory process.**

Scope

The scope of this regulation is the same as the one establishing the taxonomy and will apply to fund managers (UCITS, AIFM, EuVECA and EuSEF), institutional investors (Solvency II insurers and IORP pension funds), insurance distributors (IDD) and investment advisors and asset managers (MiFID II).

Core obligation – transparency of the sustainability risk policies

The proposal contains two different sets of obligations – one applying to all financial products in the scope of the legislation, and another set that applies only to financial products pursuing sustainable investment targets.

Disclosure applying to financial products	Disclosure applying to sustainable products only
• Integration of sustainability risks in the investment decision process and investment and insurance advice • The impact of sustainability risks on the financial returns of products • How remuneration policies are consistent with the integration of sustainability risks and the sustainable investment target	• Where a reference benchmark is used, an explanation of how the index aligns with the sustainable investment target and how the index may differ from a broad market index • Disclose the sustainable investment target and methodologies used to assess, measure and monitor the impact of sustainable investments • The overall sustainability impact by means of relevant indicators • A comparison of the impact of the financial product versus the impact of the broad overall market index

Since these disclosures will be integrated in the already existing disclosures under various sectoral legislations (UCITS, AIFMD, IDD, IORP, MiFID II), the scrutiny and enforcement will be conducted by national regulators.

The European Supervisory Agencies (ESMA, EIOPA, EBA) will, through their Joint Committee, be tasked with developing regulatory technical standards containing detailed disclosure requirements.

Low-carbon benchmarks and positive carbon impact benchmarks

Indices and benchmarks have an indirect, impact on investments, but are nevertheless important. Many investors rely on benchmarks in the process investment portfolio allocation and to measure the performance of financial products. The importance of benchmarks is also increasing tremendously with a growing share of total assets under management (AuM) being managed through passive investment strategies tracking benchmarks.

While index providers have developed a wide range of indices aimed at capturing sustainability and climate considerations, both the HLEG's final report and the Action Plan observed that current benchmarks do not reflect sustainability goals sufficiently.

The proposal puts forward an amendment to the Benchmark Regulation which establishes **two categories of benchmarks**, namely the low-carbon benchmark and the positive carbon impact benchmark:

- The **low-carbon benchmark** is based on "decarbonising" a standard benchmark. The underlying stocks would be selected based on their reduced carbon emissions, when compared to stocks constituting a standard benchmark;
- The **positive-carbon impact benchmark** is a more ambitious version aligned with the Paris agreement objectives. The underlying stocks in this benchmark would be selected on the basis of their carbon emission savings exceeding the stocks' residual carbon footprint.

In addition to the other information already to be disclosed under the Benchmark Regulation, administrators of benchmarks pursuing ESG objectives will have to **provide an explanation of how the key elements of the methodology reflect the ESG factors**. The Commission has been empowered to adopt delegated acts to further specify the minimum standards for low-carbon and positive carbon impact benchmarks.

The Commission initially considered introducing a fully harmonised regime for the methodology of the new benchmarks categories through detailed requirements for the selection and weighting of the underlying assets and requiring benchmarks' administrators to make use of the EU taxonomy regulation when designing the parameters of the methodology for selecting underlying assets. However, the Commissionopted merely to specify minimum standards for the new categories of benchmarks in future technical rules, without the need to apply the EU taxonomy. Unbundling the methodology from the EU taxonomy has been presented as a way to avoid the emergence of large categories of 'stranded assets'.

Suitability tests in the investment and insurance advisory process

MiFID II and the IDD require investment firms and insurance distributors to obtain the **necessary information about clients' investment objectives** prior to providing products. This includes the length of time the investor wishes to hold the investment, preferences regarding risk taking, risk profile, or the purpose of the investment. Based on this information, firms assess which products are "suitable" to meet their clients' needs (suitability tests).

Currently, firms do not always assess investors' non-financial preferences, such as their preferences concerning the environmental and social impacts of the investment. Therefore, the Commission proposed amendments to the delegated acts under MiFID II and the IDD requiring investment firms and insurance distributors to ask their clients about their preferences regarding sustainability and integrating these in the advisory, product selection and suitability assessment process.

The overall sequencing of the legislative measures in the package may prove to be challenging for market participants. It will be difficult for investment firms and insurance intermediaries to properly integrate sustainability preferences into the financial advisory process if the legislative proposals on Taxonomy and fiduciary duties have not yet been enacted. Many financial advisors may struggle to identify and compare financial products claiming to have a sustainable impact. However, it is true that the legislative process for the adoption of delegated acts is usually more swift than the process for adopting regulations such as the taxonomy and fiduciary duty proposals.

2 IMPACT OF THE PROPOSALS ON THE MANUFACTURING, CHEMICAL, ENERGY, AGRICULTURE AND TRANSPORT SECTORS

These legislative proposals will trigger progressive changes to the regulatory and operational environment that financial institutions exist in, but will also have tremendous impact well beyond the financial sector. The proposed package of legislative measures could in the medium and long-term have a significant impact on how corporate issuers interact with financial markets participants – such as fund managers, institutional investors, credit rating agencies and index providers – and could have an **impact on the cost of capital** for issuers. It therefore should be of paramount interest to Chief Financial Officers and treasury and investor relations department.

The introduction of an EU taxonomy for sustainable activities has been presented as being **technology neutral and activity-based**. However, it may have a significant impact on the **manufacturing, chemical, energy, agriculture and transport sectors** to name but a few. It could for example designate different sources of energy (coal, gas, oil, nuclear, renewables, etc...) as being more or less aligned with the Taxonomy. This is could in turn have an impact on the financial attractiveness and risk-return profile of particular investments in the energy sector. It could thus over time have an impact on the energy mix of Member States. In addition, the proposal on investors' duties will lead to the reorientation of capital flows to certain specific low-carbon sectors.

It is interesting to note the particular emphasis that is expected to be put on the **transport sector**. Indeed, in the recitals of the taxonomy proposal, the Commission has called for the introduction of appropriate technical screening criteria for this sector, given its contribution close to 26% of total greenhouse gas emissions in the EU.

Moreover, the taxonomy makes for example concrete references to **EU legislation on the use of water**, to the importance of the **circular economy** and to the **protection of the healthy ecosystems**. This could have some important consequences for the agricultural and manufacturing sector.

Finally, the proper implementation and application of all the legislative proposals of the package will ultimately depend on the quality and standardisation of the data the financial sector can obtain from issuers. With time, this may translate into additional and more granular reporting requirements around sustainability and climate change related data for corporate issuers. The Financial Stability Board (FSB) Task Force on Climate-related Financial Disclosures (TCFD) made specific recommendations on this issue, which received a strong support from hundreds of companies on a voluntary basis. However, we expect that over time this will move towards more harmonised and compulsory reporting requirements, possibly already during the mandate of the next Commission starting in 2019. The Commission committed in its Action Plan to launch a fitness check of EU legislation on public corporate reporting, including the Non-Financial Information (NFI) Directive and to revise by Q2 2018 to revise the guidelines on non-financial information. adopting regulations such as the taxonomy and fiduciary duty proposals.

3 NEXT STEPS IN THE EU LEGISLATIVE PROCESS

Now that the Commission has published its proposals, it will move ahead in ordinary legislative procedure, with Council and the European Parliament having to prepare their respective positions ahead of trilogue negotiations. In the Council, Member States generally support the idea of a taxonomy as long as it would be technology-neutral and leave sufficient room for market development. As mentioned above, some Member States may be very reluctant to give so much power to the Commission through delegated acts, especially if the technical rules

may have such an impact over the manufacturing, chemical, energy, agriculture and transport sectors, with the fiscal, social and employment implications it carries.

The European Parliament recently adopted a report on sustainable finance. Even if it is not legally binding, this report will be important on a political level and could be used by the Commission to legitimise certain policy actions Member States are opposed to. It also gives a first sign of how MEPs will deal with sustainable finance. The list of measures called for by MEPs is broader and more profound than the Commission's and on a more accelerated timetable. The report was passed with a large majority in the European Parliament. Among the MEPs' demands which go beyond what the Action Plan envisages include the phasing out of direct and indirect subsidies for fossil fuels or a binding legal framework for investors' due diligence on ESG factors.

The Greens have been given the position of rapporteur to lead the negotiations on the taxonomy proposal, with Molly Scott-Cato MEP (UK) a likely candidate as rapporteur. The rapporteur for the proposal on fiduciary duties will be Paul Tang (the Netherlands). He has been very active during the negotiations on the own-initiative report on sustainable finance and is expected to propose ambitious amendments to the proposals. The rapporteur for the regulation on low-carbon benchmarks will be Neena Gill.

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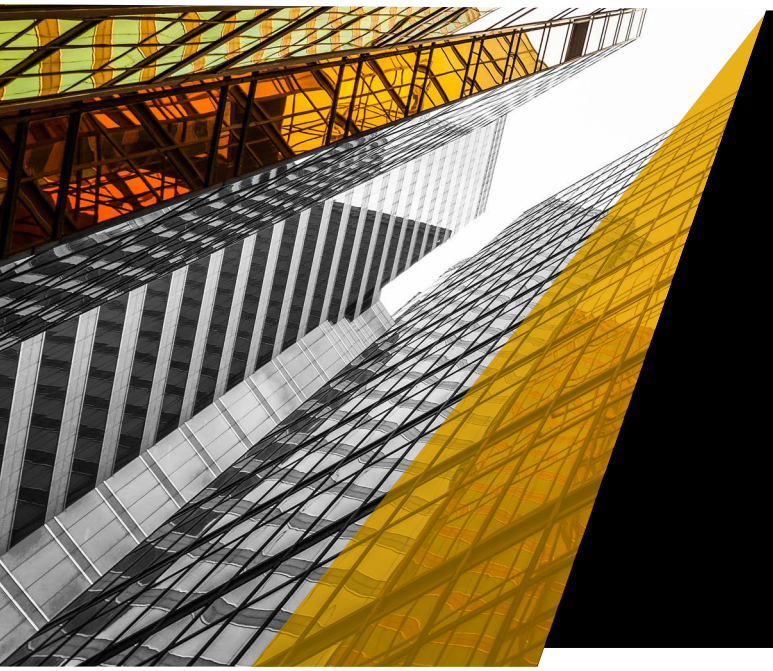

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