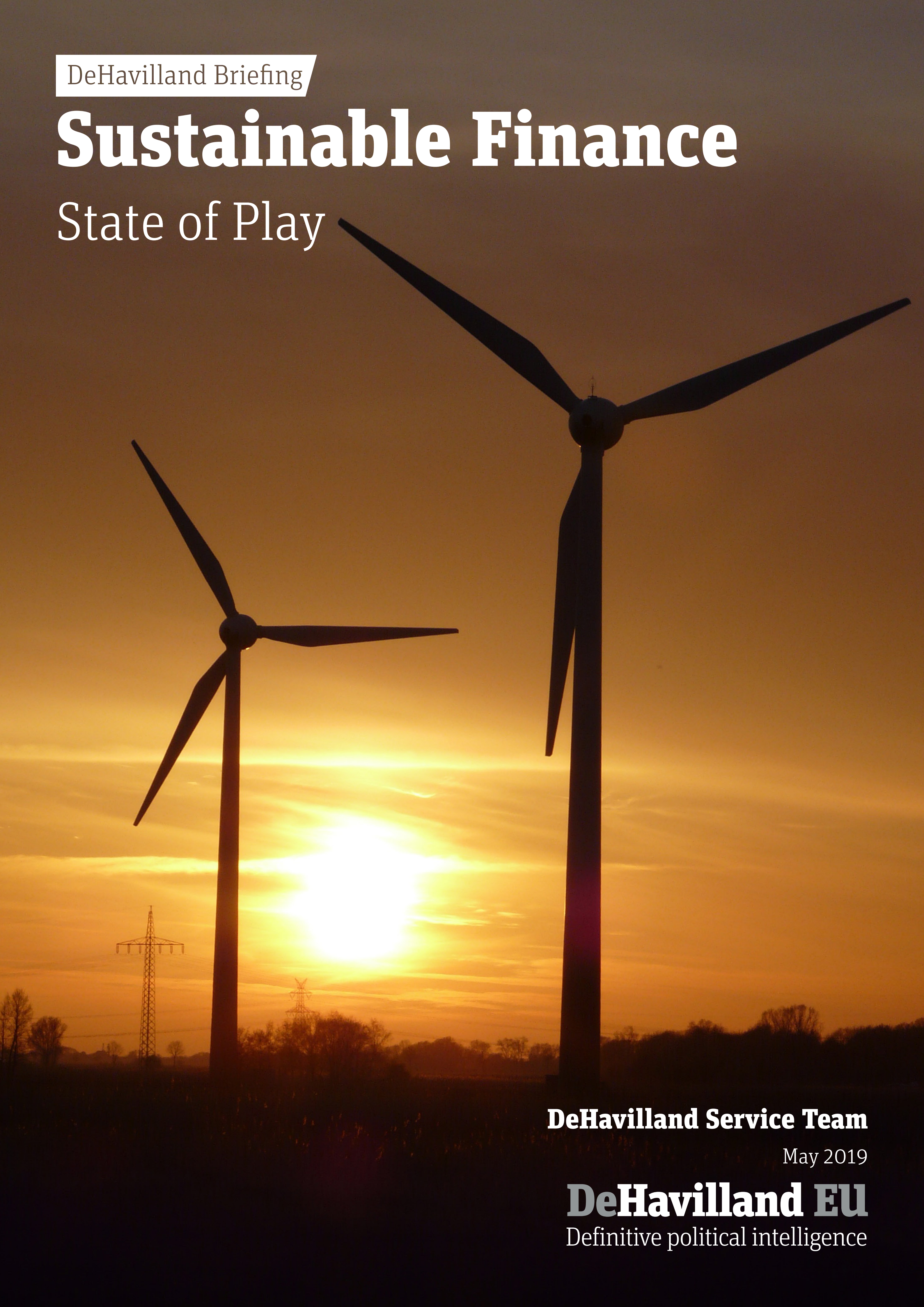
DeHavilland Briefing

Sustainable Finance

State of Play



DeHavilland Service Team

May 2019

DeHavilland EU

Definitive political intelligence

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Introduction

Sustainability in finance – and considering environmental, social and governance (ESG) issues before investing – has gained traction in the last decade. In 2015, the need for this to happen on a larger scale was formally recognised with the adoption of the UN 2030 Agenda and Sustainable Development Goals and the Paris Climate Agreement. The Paris Agreement, in particular, includes the commitment to align financial flows with a pathway towards low-carbon and climate-resilient development. To achieve the EU's 2030 targets agreed in Paris, including a 40% cut in greenhouse gas emissions, the European Commission ('The Commission') estimates an investment gap of 180 billion EUR per year will have to be filled.

According to the Commission, sustainable finance is the provision of finance to investments taking into account ESG considerations and includes a strong green finance component that aims to support economic growth while also aiming to:

- Reduce pressures on the environment;
- Addressing green-house gas emissions and tackling pollution; and
- Minimising waste and improving efficiency in the use of natural resources.

It also encompasses increasing awareness of and transparency on:

- The risks which may have an impact on the sustainability of the financial system; and
- The need for financial and corporate actors to mitigate those risks through appropriate governance.

Yet, many questions remain open. What exactly is the difference between a "normal" investment and a sustainable investment? Does sustainability in investment know gradations? Do investment firms have to go beyond "negative screening", i.e. the exclusion of assets deemed unsavoury? How do investments in companies who aim to become more sustainable in the future need to be treated when that particular business is at the moment a polluter?

The Commission

To tackle the questions above, the Commission, on 8 March 2018 published an action plan for financing sustainable growth. The plan is a response to recommendations from the High-Level Expert Group (HLEG) on Sustainable Finance, which were submitted to the Commission on 31 January 2018.

The action plan on sustainable finance adopted by the European Commission in March 2018 has 3 main objectives:

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

Technical and preparatory work

The Commission set up a technical expert group on sustainable finance (TEG) to assist it notably in the development of a unified classification system for sustainable economic activities, an EU green bond standard, methodologies for low-carbon indices, and metrics for climate-related disclosure. The TEG began work in July 2018 and will operate until June 2019, with a possible extension until end-2019. To ensure transparency the TEG also published an outreach plan, which included plans for open consultations in 2018 and 2019. The outreach plan is updated regularly.

On 6 March 2019, the TEG published a consultation on their preliminary recommendations for the creation of an EU Green Bond Standard (EU GBS), and their interim report outlining the status of the work conducted so far. This interim report proposes the content of an EU GBS, explains its purpose and sets its ambition level. It also explains how the TEG believes the creation of the proposed EU GBS will address the barriers hindering the green bond market's further development and will support its role in channelling substantial financial flows to green projects. The deadline for providing feedback was 7 April.

In addition, the Commission has been seeking feedback on amendments to delegated acts under the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients. The Commission intends to clarify how asset managers, insurance companies, and investment or insurance advisors should integrate sustainability risks and, where relevant, other sustainability factors in the areas of organisational requirements, operating conditions, risk management and target market assessment. To achieve this aim, the Commission tasked the European Securities and Markets

Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) with drafting advisory reports on suggested amendments for a number of existing legislative acts. Both ESMA and EIOPA held consultations on their suggestion between 19 December 2018 and 19 February 2019, which led to a number of reports submitted to the Commission on 3 May 2019. These included:

- Advice on integrating sustainability risk and factors in MiFID II;
- Advice on integrating sustainability risk and factors in the Undertakings for Collective Investment in Transferable Securities Directive and the Alternative Investment Fund Managers Directive; and
- Advice on integrating sustainability risk and factors in Solvency II and the Insurance Distribution Directive.

Legislative proposals

In May 2018, the Commission proposed a first package of legislative measures implementing several key actions announced in its action plan on sustainable finance. The package includes:

- A proposal for a Regulation on the establishment of a framework to facilitate sustainable investment. This Regulation would establish the conditions and the framework to gradually create a unified classification system ('taxonomy') on what can be considered an environmentally sustainable economic activity. This is a first and essential step in the efforts to channel investments into sustainable activities.
- A proposal for a Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU)2016/2341. This Regulation will introduce disclosure obligations on how institutional investors and asset managers operating in the EU, integrate environmental, social and governance (ESG) factors in their risk processes. Requirements to integrate ESG factors in investment decision-making processes, as part of their duties towards investors and beneficiaries, will be further specified through delegated acts.
- A proposal for a Regulation amending the Benchmark Regulation. The proposed amendment will create a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks, which will provide investors with better information on the carbon footprint of their investments.

Progress on the three proposals has generally been swift. MEPs were keen on voting on their Committee Reports before Christmas 2018 with the hopes of reaching a vote in the plenary session before the end of the Eighth European Parliament's mandate. For two of the three files they were able to achieve this. On the Council's side, the Working Party on Financial Services (WPFS) is taking the lead and has regularly met to continue its examination of the proposals. The WPFS has split up the package and generally discusses either the Taxonomy proposal – which is still ongoing – or the Disclosures and Benchmarks proposals – for which political agreements have been reached in this parliamentary term.

What follows below is an overview of the steps that have already been taken with regards to all three proposals.

State of Play

Taxonomy

Initially assigned to the ECON committee, Parliament subsequently re-assigned the dossier to a joint committee composed of the ECON and the ENVI committee. ENVI and ECON published their joint draft Report on November 2018 and, after a highly intensive vote – mainly due to a number of compromise amendments falling through and the Greens protesting this fact – on 11 March, the joint committee's Report was adopted.

The Report, among other things, holds that criteria and indicators for determining the degree of environmental sustainability of an economic activity should be gradually harmonised at EU level. Such harmonised criteria and indicators should be reasonable and proportionate, as well as ensuring coherence with existing EU legislation. Furthermore, they should take into account the environmental impact on the entire industrial value chain and the life-cycle of technologies. The report proposes that the relevant European supervisory authorities monitor the markets for financial products covered by the Regulation. The report also reinforces the role of the Platform on Sustainable Finance, by including experts from different backgrounds, and tasking it with advising the Commission on possible amendments needed. The Report also calls for regular reviews of the regulation, by 31 December 2021 and subsequently every three years thereafter. The Commission should review whether the regulation creates excessive administrative burden or if the data needed by financial market participants are not sufficiently available.

The European Parliament, in its Plenary Session of 28 March formally adopted their first reading report. The report also constitutes the Parliament's mandate for the interinstitutional negotiations with the Council of the EU, which could start up as early as September 2019.

On the Council of the EU side, work in the Working Party on Financial Services is still ongoing. The last meeting held regarding the proposal took place on 23 May 2019. It is likely that the Working Party will aim to finish its examination by summer 2019, opening the road for Council to adopt its own negotiation mandate on the basis of which talks with the European Parliament could begin. The timeline might shift depending on the controversy within the Council, but it is highly likely that the incoming Finish presidency will make this proposal a priority file.

With regards to the taxonomy, the TEG, on 7 December, invited interested parties to provide feedback on the first proposed activities that contribute substantially to climate change mitigation and on the usability of this first list of activities. TEG also identified areas where additional technical expertise is needed. The Commission will therefore host several workshops with the purpose of gathering this expertise. More information on the work done by the TEG can be found here.

Initiative	European Parliament	Council of the EU	Commission/Others
Establishment of a framework to facilitate sustainable investment [COD/2018/0178]	**Rapporteur: Bas Eickhout (Verts/ALE) & Pietikäinen Sirpa (EPP)** • 16/11/18: ECON/ENVI publishes draft Report • 11//03/19: ECON/ENVI vote on draft Report • 13/03/19: ECON/ENVI publish Report • 28/03/19: Plenary discusses proposal • 28/03/19: Plenary adopts report	• 20/07/18: Working Party on Financial Services discusses the proposal • 26/07/18: Working Party on Financial Services discusses the proposal • 12/10/18: Working Party on Financial Services discusses the proposal • 15/11/18 Working Party on Financial Services discusses the proposal • 26/11/18 Working Party on Financial Services discusses the proposal • 19/12/18: Working Party on Financial Services discusses the proposal • 09/04/2019: Working Party on Financial Services discusses the proposal • 07/05/19: Working Party on Financial Services discusses the proposal • 23/05/19: Working Party on Financial Services discusses the proposal	• 24/05/18: Initial Proposal

Disclosures

On 18 October 2018, the ECON Committee debated the proposal. There appeared to be broad support for the amendments provided to the file. However, ALDE expressed their reservations around the unintended consequences of Regulation, and these concerns were also echoed by Mr Sant from the S&D, who called for an impact assessment into the consequences for SMEs.

ALDE also expressed concerns around scope, suggesting that remuneration and due diligence should be left out of the discussion, however, the other groups did not appear to share this view. On remuneration, the EPP felt Mr Tang's proposal was too ambitious and could not support it, however, it was supported by the Greens. ECON adopted its Report on 5 November and voted in favour of starting interinstitutional negotiations. After a fairly short round of trilogue meetings, a provisional agreement was reached on 7 March. The Agreement sets out a harmonised EU approach to the integration of sustainability risks and opportunities into the procedures of institutional investors.

It requires them to disclose:

- The procedures they have in place to integrate environmental and social risks into their investment and advisory process;
- The extent to which those risks might have an impact on the profitability of the investment;
- Where institutional investors claim to be pursuing a "green" investment strategy, information on how this strategy is implemented and the sustainability or climate impact of their products and portfolios.

The proposed Regulation should in practice limit possible "greenwashing" – i.e. the risk that products and services which are marketed as sustainable or climate friendly in reality do not meet the sustainability/climate objectives claimed to be pursued.

On 19 March 2019, the European Economic and Social Committee published its Opinion on the proposal. The EESC highlighted that its Opinion focuses on measures linked to redirecting capital flows towards sustainable investments and, as such, goes to the very heart of the fiduciary obligations of capital market participants, whose weakest component – end investors – will be able to bring their sustainability preferences into line with their informed investment decisions. The EESC also firmly believes in designing sustainable pan-European financial products, as it is convinced that they will enable Europe to do bigger and better things. The EESC also endorses the Commission's proposal to set up a platform on sustainable finance, comprising experts from both the public and private sectors and states that it should be involved in this platform. Lastly, the EESC highlights the need to ensure the involvement of civil society and the social partners at every stage of the process.

Finally, the proposal was adopted in the first and single reading in the Plenary Session of the European Parliament on 18 April. The proposal now awaits formal approval in the Council after which it can be published in the Official Journal of the EU and enter into force.

Initiative	European Parliament	Council of the EU	Commission/Others
Disclosures relating to sustainable investments and sustainability risks [COD/2018/0179]	**Rapporteur: Paul Tang (S&D)** • 02/08/2018: ECON published Draft Report • 10/10/18: ENVI vote on Opinion • 11/10/18: ENVI publishes Opinion • 05/11/18: ECON vote • 09/11/18: ECON published Report • 18/04/19: Plenary adopts proposal	• 20/07/18: Working Party on Financial Services discusses the proposal • 05/10/18: Working Party on Financial Services discusses the proposal • 26/11/18 Working Party on Financial Services discusses the proposal • 12//12/18: Working Party on Financial Services discusses the proposal • 17/12/18: Presidency Compromise text published (trilogue mandate) • 14/01/19: Trilogue takes place • 24/01/19: Working Party on Financial Services discusses proposal • 28/01/19: Trilogue takes place • 08/02/19: Working Party on Financial Services discusses proposal • 12/02/19: Trilogue takes place • 22/02/19: Working Party on Financial Services discusses proposal • 27/02/19: Trilogue takes place • 01/03/19: Working Party on Financial Services discusses proposal • 06-07/03/19: Trilogue agreement reached	• 24/05/18: Initial Proposal • 19/03/19: EESC Opinion

Benchmarks

On 18 October, the ECON Committee also debated the Benchmarks proposal. The Rapporteur for the Committee noted that the financial sector appeared to be “lagging behind” other sectors in terms of becoming green. However, there appeared to be disagreement within the Committee on the practicality of proposals, in particular that all indices should be green by 2022. The ECR and EPP expressed their doubt that this could be achieved. Additionally, there were concerns around the scope of the benchmarks, and their potential to allow for ‘green washing’. Many MEPs felt this was a sensitive sector and cautioned against over-legislation or over-regulation. Finally, there was some confusion around the definition of the low-carbon and carbon-positive benchmarks, which was eventually cleared up the Commission representative.

The vote on the Report on the ECON Committee was originally scheduled for 3 December, which was afterwards postponed to respectively 6, 10 and 13 December. The postponement was requested by the shadow-rapporteur of the S&D Group, Pervenche Berès, who regretted not being able to coordinate with the EPP Group on outstanding issues because the Rapporteur had not been in Brussels that week.

The proposal afterwards went into trilogue discussions which lead to a provisional agreement on 25 February. The agreement creates two new categories of low-carbon benchmarks: a climate-transition benchmark and a specialised benchmark which brings investment portfolios in line with the Paris Agreement goal to limit the global temperature increase to 1.5˚above pre-industrial levels. The two new benchmark categories are voluntary labels designed to orient the choice of investors who wish to adopt a climate-conscious investment strategy. The climate-transition benchmark will offer a low-carbon alternative to the commonly used benchmarks. The Paris-aligned benchmark will only comprise companies that can demonstrate that they are aligned with a 1.5˚ target. Similarly to the Disclosures proposal, the new labels are also designed to give additional assurances to avoid “greenwashing”.

Finally, the proposal was adopted in the first and single reading in the Plenary Session of the European Parliament on 26 March. The proposal now awaits formal approval in the Council after which it can be published in the Official Journal of the EU and enter into force.

The EU institutions agreed to grant providers of "critical benchmarks" — interest rates such as Euribor or EONIA — two extra years until 31 December 2021 to comply with the new Benchmark Regulation requirements. Given the crucial importance of third-country benchmarks for EU companies, the extra two years for benchmarks produced outside the EU was also introduced to provide additional time for work with non-EU regulators on how these benchmarks can be recognised as equivalent or otherwise endorsed for use in the EU.

Initiative	European Parliament	Council of the EU	Commission/Others
Low carbon benchmarks and positive carbon impact benchmarks [COD/2018/0180]	**Rapporteur: Neena Gill (S&D)** • 27/09/18: ECON publishes Draft Report • 20/11/18: ENVI vote on Opinion • 22/11/18: ENVI publishes Opinion • 13/12/18: ECON vote • 20/12/18: ECON publishes Report • 26/03/19: Plenary adopts proposal	• 20/07/18: Working Party on Financial Services discusses the proposal • 05/10/18: Working Party on Financial Services discusses the proposal • 26/11/18 Working Party on Financial Services discusses the proposal • 12/12/18: Working Party on Financial Services discusses the proposal • 14/12/18: Presidency Compromise text published (trilogue mandate) • 16/01/19: Trilogue takes place • 24/01/19: Working Party on Financial Services discusses proposal • 31/01/19: Trilogue takes place • 08/02/19: Working Party on Financial Services discusses proposal • 13/02/19: Trilogue takes place • 22/02/19: Working Party on Financial Serives discusses proposal • 25/02/19: Trilogue takes place • 25/02/19: Trilogue agreement reached • 01/03/19: Working Party on Financial Services discusses proposal	• 24/05/18: Initial Proposal

What is Next?

Broadly speaking all three proposals have progressed through the legislative process at a very fast rate, underlining the importance the EU institutions give to these files.

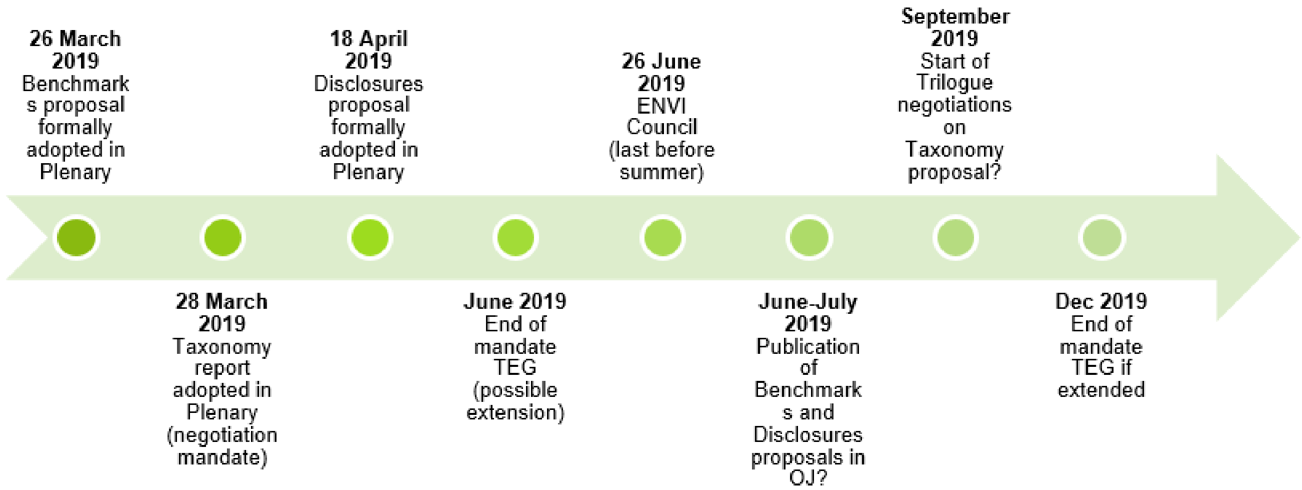
Both the Benchmarks and Disclosures proposals have been formally adopted by the European Parliament and now await formal adoption by the Council of the EU before they can be published in the Official Journal of the EU and enter into force. Based on analysis of previous files, this could happen as early as end of June 2019.

The adoption of the Taxonomy proposal in the European Parliament's plenary session of 28 March resulted in a parliamentary mandate to enter into interinstitutional negotiations (trilogue discussions) with the Council of the EU. As Parliament will break up for elections in May, negotiations on the file are only expected to start earliest in September 2019 as the new ECON Committee is only formally sworn in on 8 July after which it breaks up for Summer Recess.

Alongside the Parliament, the Council of the EU, in the Working Party on Financial Services (WPFS) will continue its article-by-article evaluation of the Taxonomy proposal, on the basis of which the serving Presidency (Romania January-June 2019, Finland July-December 2019) adapts the proposal to reflect the position reached by the WPFS. This will constitute a general approach, which needs to be endorsed during a session of the Council. After the endorsement, the general approach forms the mandate for trilogue discussions with the European Parliament. As the Council of the EU does not break up for elections work on this will continue past May. The last Economic and Financial Affairs (ECOFIN) Council meeting before the Summer recess will take place on 14 June. If the ECOFIN Council does not adopt a general approach in June, work in the WPFS will continue over summer with a next ECOFIN meeting only taking place in September 2019 – no date set yet.

After the trilogue discussions on the Taxonomy Proposal are completed and a compromise legal text has been found that is acceptable to all three institutions, both the Council of the EU and Parliament in its plenary session need to formally approve the proposal. If the legislation is formally adopted in both institutions, the legal text is published in the Official Journal before entering into force.

Provisional Timeline



Potential Timeframe

Looking at the 18-month Programme of the Council highlighting the priorities of the Romanian, Finnish and Hungarian Presidencies, it seems like sustainable finance will be considered a priority:

> *"Action is needed in **the transition towards a low carbon economy, in particular in sectors where decarbonisation is lagging behind**, and in implementing measures towards improving energy efficiency, while providing secure and affordable sustainable energy for European citizens. The modernisation of the economy and the mainstreaming of climate policies should be seen as an economic opportunity offering new jobs and generating growth."*

Yet, on closer inspection of the priority dossiers under the Romanian EU Council Presidency, which runs from January-June 2019, it is clear that the sustainable finance proposals are not mentioned. Work during the Romanian Council Presidency has however progressed at a fast pace for the Benchmarks and Disclosures proposal. The Taxonomy proposal, which will define exactly what is to be understood with sustainable investment, is more sensitive. As the file is still in Working Party stage, it seems unlikely that the Romanian Presidency will be able to reach a breakthrough before the Summer recess. This means that work on the file will be passed over to the incoming Finish Presidency.

Finland has already taken initiative on sustainable finance on an international level with its work in the Coalition of Finance Ministers for Climate Action and the Helsinki Principles. These principles serve as a guide for participating Member States to support sustainable finance measures on a national level. At the moment, 26 countries have signed on to the Helsinki Principles: Austria, Chile, Colombia, Costa Rica, Cote d'Ivoire, Denmark, Ecuador, Finland, France, Fiji, Germany, Guatemala, Iceland, Ireland, Kenya, Luxembourg, Marshall Islands, Mexico, Netherlands, Nigeria, Norway, Philippines, Spain, Sweden, Uganda, and United Kingdom. Alongside the Principles, the Council of the EU also published a letter by the Finish and Chilean Government outlining the next steps for Member Countries, including a Sherpa meeting in Santiago tentatively scheduled for 4-5 June.

Combined with the mandate of the TEG which is set to conclude its work in June 2019, and can be extended until December 2019, it seems likely that work on the Taxonomy proposal will continue over Summer and that work done by the Coalition of Finance Minsters for Climate Action will also trickle down to the European proposal. As trilogue negotiations are still outstanding – with a new European Parliament which will want to leave its own mark on the proposal – the road ahead for the Taxonomy proposal might be longer than initially expected. Given Finland's focus on sustainability it however will look to finish the proposal by the end of 2019, and important date as the Taxonomy proposal will set the future framework for defining sustainability across the EU.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