Aligning Europe’s financial system with the Paris Agreement

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The Institutional Investors Group on Climate Change (IIGCC) – the investor voice on climate solutions in Europe – is a collaborative forum with 143 mainly mainstream investors across 12 countries with nearly €20 trillion assets under management (including 9 of the top ten largest European pension funds or asset managers). Its mission is to provide investors with a common voice to encourage public policies, investment practices and corporate behaviour which address long-term risks and opportunities associated with climate change.

IIGCC members consider it a fiduciary duty to ensure that stranded asset risk or other losses from climate change are minimised so that opportunities presented by climate action and the transition to a low carbon economy are maximised. They believe renewable energy, low carbon technologies and energy efficiency present significant investment opportunities which could foster European economic growth, create jobs, improve energy security and better protect public health.

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### Executive Summary

This paper is based on IIGCC’s response to the consultation on the Interim Report of the EU’s High-Level Expert Group on Sustainable Finance\(^1\). It sets out IIGCC’s views on priority policy areas for the EU to focus on over the coming months and years within the domain of sustainable finance. This paper should not be interpreted as exhaustive; IIGCC’s position will be adapted and updated over time.

In summary, in its core recommendations IIGCC urges the EU to:

| 1 | Set out a **clear, long-term policy framework for the real economy** – encompassing energy, transport and industry – **backed up by concrete targets and objectives**, as a priority issue, to move capital to support a transition to a sustainable low carbon economy. |
| 2 | Work towards determining a definition of **fiduciary duty that encompasses all financially material sustainability issues**. |
| 3 | Adopt a global leadership position in **implementation of the TCFD recommendations**, initially through fostering and sharing best practice at national level to allow for the future development of possible guidance or legislation. |
| 4 | Consider, in consultation with the financial community, the merits of developing a standardised **disclosure template for green bonds** to support the provision of more relevant, reliable, and comparable information. |
| 5 | Develop guidance on how different types of investment are compatible (or not) with **long-term EU policy targets**. |
| 6 | Pursue opportunities to encourage more **research on sustainability issues** and on the **alignment of fund manager incentives** towards the longer term. |
| 7 | Continue work to develop a **classification system** for sustainable assets and financial products. |
| 8 | Encourage Credit Ratings Agencies to **incorporate sustainability and long-term risks into their ratings frameworks**. |
| 9 | Reflect on how it could help to **bridge the current gap** that exists within the European financial system – whereby expertise and activities are concentrated in a handful of countries – through the provision of information on best practice, resources, and training. |
| 10 | Ensure that all work undertaken to establish new EU norms, rules or practices builds upon **existing best practice**, takes into account **global perspectives**, and is pursued in consultation with **established experts**. |

1 A strong pipeline of sustainable projects for investment

It is vital that the EU creates a strong and visible pipeline of sustainable investment projects ready for investment at scale.

In seeking to achieve this, the long-term policy framework for the real economy must remain the priority: the financial sector will only respond at the pace and scale required if the EU signals clear direction and expectations across all economic sectors.

The EU should therefore establish (but not necessarily limit itself to):

- A robust EU Emissions Trading System providing a strong, long-term carbon price signal;
- Long-term targets, consistent with the Paris Agreement and 2050 objectives, across Clean Energy Package legislation: Governance, Energy Efficiency, Renewables, Energy Performance of Buildings;
- Strong long-term targets for the transport sector to stimulate electrification and alternative fuels;
- An ambitious framework allowing the EU to increase its Nationally Determined Contribution to the Paris Agreement over time, starting in 2018;
- Rules for National Energy & Climate Plans to include capital-raising provisions;
- Technical assistance for project development (in particular, those at a smaller scale), such as energy efficiency, demand side management and transport.

Better and more consistent reporting on the sustainability performance of infrastructure companies and funds is also required. There are several market-driven initiatives in this area (e.g. GRESB Infrastructure and Real Estate assessments, and the UK Green Investment Bank methodology) and the EU and/or European Investment Bank could help support adoption by playing an active role through both funding and participation.

2 Fiduciary duty that encompasses sustainability

Mismatched time horizons – and short-termism versus long-term perspectives – are frequently identified as an obstacle to the creation of sustainable investments. To address this mismatch, the EU should provide legal clarification that the prudent person rule, the EU equivalent of the concept of fiduciary duty, allows for the consideration of environmental, social and governance factors.

Currently this concept is fragmented; IIGCC has long argued that any functional definition of fiduciary duty for investors must encompass sustainability factors, so that the finance sector can integrate these issues into decisions and mitigate the risks that carbon represents over the next 20 to 30 years.

At the core, must be the identification, disclosure and effective management of the huge physical and transition risks posed by climate change. Asset owners and managers must be aware of the carbon in their portfolios and the associated risks, and carbon risk data must be used in investment decisions. The EU could also encourage the OECD to strengthen the current G20-OECD High-level Principles of Long-term Investment Financing by Institutional Investors.

The EU could also encourage Member States to review their fiduciary duty regulation (as each country has a different approach to implementation), clarify arrangements in each jurisdiction, and consult on harmonising fiduciary duty and responsible investment-related legislation across Europe. The UNEP FI work done on fiduciary duty – analysing the EU, Germany and the UK – provides a valuable starting point for this work.
3 Implementing a disclosure regime consistent with the TCFD

IIGCC urges the EU to give strong encouragement to the implementation of recommendations made by the Task Force on Climate Related Disclosures (TCFD). The EU should seek to position itself as a global leader on the issue of disclosure, fostering and sharing best practice to enable the future development of possible guidance or legislation. For example, the EU could monitor and evaluate the impact and effectiveness of the French Energy Transition Article 173 and other national instruments, and – if appropriate – consider how similar legislation could be applied at EU level.

4 A European standard and label for green bonds and other sustainable assets

The EU should ensure that work to develop any standard and label in this area builds on existing best practice (e.g. the Green Bond Principles and Climate Bond Standards) and encourages increased harmonisation and convergence.

The EU could test appetites for development of a standardised disclosure template for green bonds to support more relevant, reliable, and comparable information and to foster common features across national jurisdictions.

However, it should be noted that, ultimately, any standardisation will need to be taken up by a body with global reach.

5 Guidance on compatibility of long-term EU policy targets with different types of investment

The EU’s High-Level Expert Group on Sustainable Finance has proposed the creation of a “Sustainable Infrastructure Europe” initiative to channel finance into sustainable projects. In IIGCC’s view, the EU should be wary of assuming that the creation of a new institution (or an expanded existing institution) will automatically resolve issues relating to match-making, provision of advice and the pipeline of sustainable projects.

We advise that the EU explores options involving Public-Private Partnership structures to improve the market and provide more uniformity, and the creation of specialised units within existing institutions such as the European Investment Bank, as well as the provision of a strong long-term policy framework for the real economy (see recommendation 1).

If the EU pursues a new, expanded or restructured initiative, a key role would be to translate long-term EU policy targets into guidelines on what types of (or parameters for) investment are compatible, or not, and into information on what type and level of risk investors face if they back projects that have poor compatibility with long-term targets. Projects related to buildings, energy efficiency, demand side management and transport should be included within the remit, and services could provide advice on: project development, the optimal distribution of public versus private ownership, the integration of commercial and sustainability investment criteria, and technical assistance. Market participants could also be encouraged to aggregate assets to accelerate investment (particularly into low-carbon energy generation and energy efficiency).
6 Research on sustainability issues and long-term alignment of fund manager incentives

To drive better alignment between governance of the investment / analyst community and long-term sustainability considerations in the real economy, EU action should be two-fold: encouraging more research on ESG issues; and realigning fund manager incentives towards the longer term.

On the former, currently only a few fund managers direct research towards long term investment behaviour, voting advice and stewardship work, despite evidence that sustainability issues can impact their investments. The EU could make more monies available for research in this area (whether via H2020 or other funding schemes). It could also consider including incentives in appropriate legislative instruments, e.g. in guidance on implementing the Markets in Financial Instruments Directive.

On the latter, the norm for fund manager incentives is to have rolling performance horizons of between one and three years, i.e. that ignore the long term. Fund managers are often also pressured to maintain high levels of short-term performance. Further debate is required on how best to align remuneration of fund managers and the pursuit of long-term sustainable investment practices.

7 A classification system for sustainable assets and financial products

Complexity is a key barrier to investment, specifically around the definition of what ‘green’ or ‘sustainable’ actually means. IIGCC therefore strongly supports the development of an EU taxonomy for sustainable assets and financial products.

Further thinking and discussion is required at EU level, drawing on existing best practice and existing taxonomies that have been developed by different actors in the market (e.g. Green Bond Principles), as well as the current debate within European industry (i.e. “clean coal” is not generally considered to be sustainable, and the persistently open question around nuclear energy).

Thinking should also build on the previous and existing efforts of institutions such as the European Investment Bank and European Bank for Reconstruction and Development, and should embody the principles of transparency and cost-effectiveness.

Any emerging taxonomy also needs to be made comprehensive across asset classes, based on a full understanding of the supply-chains that underpin ‘sustainable’ products and services, flexible enough to accommodate rapid technological evolution, and linked to wider EU climate and energy policy objectives. There should also be a clear process for reviewing (and revising) any eventual taxonomy on an agreed timeframe to capture changes in the market.

8 Incorporation of sustainability into credit ratings

The classification and evaluation of ‘sustainable’ investment practices by credit rating agencies already have a substantial impact on investor decision making. Forecasting the future gets harder and more complex within longer time frames; as a result, some Credit Rating Agencies may focus upon the short-term and fail to factor sustainability concerns into their ratings.

The EU could encourage (e.g. initially through voluntary guidance) credit ratings agencies to take steps to incorporate sustainability factors and long-term risks into their ratings, looking at issues that are relevant over the duration of the bond itself.
Bridging the gap within the EU financial system

The EU should reflect on the current reality whereby the European financial system is concentrated in a handful of countries, and consider how it could help to bridge the gap this creates with countries that do not enjoy such easy access to the expertise this presents. Consideration should be given to options such as spreading best practice, and providing resources and training to regulators, decision-makers and practitioners in countries where the financial system lacks a substantial base.

A global and well-evidenced approach

In all work to establish new EU norms, rules or practices, the EU should ensure that these are built upon existing best practice, take into account global perspectives, and are developed in conjunction with established experts.

To that end, the EU should seek to draw on the wealth of existing best practice available at regional, national and market level when developing new initiatives, and undertake thorough consultation with the range of experts on these topics who are active within the finance and investment community, including in private organisations, NGOs, central and multi-lateral banks, and others.

It will be particularly important for the EU to ensure that it maintains a strong commitment to thinking globally. For market reform to be truly effective we will need to see systemic reform on both a global and regional level. The EU can and should be a leader within its own domain, but ultimately it will need to persuade other major economies to pursue parallel efforts and back wider efforts to deliver global change.