Improving the pricing of risk: Aligning the EU financial system and climate change
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IIGCC

The Institutional Investors Group on Climate Change (IIGCC) is the investor voice on climate solutions in Europe. It is a forum for collaboration for over 120 investors representing over €13 trillion assets under management and including some of the largest pension funds and asset managers in Europe. IIGCC’s 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.

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Executive summary

The costs and benefits of the low-carbon transition and the orderliness of the change, will depend on how well the financial system and the real economy anticipate and encourage the shift. Financial regulation needs to enable and facilitate the changes occurring in the real economy as a consequence of the 2030 framework, technology innovation, and the emergence of new business models. This relates to managing the risks of the transition and to physical impacts as well as to the mobilisation of capital to take advantage of opportunities. Climate risk needs to be better reflected in the price of risk so that a shift in capital can be encouraged.

Building on the 80-95% emission reduction goal adopted by Heads of State and Government of the European Union for 2050, the world agreed to achieve global emissions neutrality in the second half of the century at COP 21 in Paris. The direction of travel – and the intermediate steps out to 2030 on that path – are now clear.

IIGCC has continuously called for European leadership on climate change – something Europe rightly prides itself for. However, this leadership must be reinforced by enabling the financial system to fully support action against climate change, in line with a wider G20 trend. For this reason, we welcome the establishment of an expert group on green finance that EU Capital Markets Union Vice President Valdis Dombrovskis has recently announced.

This paper sets out IIGCC’s position on the alignment of the financial system and climate change. It contains recommendations for policy-makers on how to:

1. Foster a financial system that encompasses time horizons capable of dealing with the challenge of climate change and price risk appropriately: in particular, we welcome the creation of a special infrastructure category under Solvency II and encourage the integration of infrastructure corporations into this category. We also welcome the 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. We call on EU institutions to develop an action plan to make the capital markets union more sustainable.

2. Disclose risks arising from the transition and from physical impacts of climate change: in particular, we support the disclosure of climate risk across the investment chain, from companies to investors themselves.

3. Mobilise the necessary capital for a swift and smooth transition to a low-carbon energy system: we make a number of recommendations for the reform of the Emissions Trading Scheme in the EU, the decarbonisation of transport and of the buildings sector. These policy interventions remain critical to shifting capital.
**Time horizons: Encouraging long-term investment**

**Solvency II**

Stimulating long-term investment into sustainable infrastructure is a crucial challenge given the significant investment needs across the European Union and in emerging markets. Historically, long term investments into infrastructure have been hampered by their unfavourable treatment under Solvency II. Direct infrastructure investments with a buy-to-hold intention not only match favourably with our liabilities, they also have a significantly more favourable risk profile than suggested by standard risk analyses that are more appropriate for other alternative investments. This has to do with their predictable cash flows, the fact that they are often backed by government guarantees, and long project durations.

We appreciate that Solvency II encourages long-term investment that matches assets and liabilities, which can be unlocked for example by timing the maturing of bonds with liabilities. Infrastructure assets have a unique risk profile that warrants defining them as their own asset class.

*IIGCC welcomes the fact that under the Solvency II standard formula, long term direct infrastructure investments as well as investments into infrastructure funds will receive more favourable risk charges than previously. IIGCC also welcomes the fact that infrastructure bonds will be treated like corporate bonds rather than as securitised products. However, these improvements are still limited to a very narrow definition of direct infrastructure assets. For example, many assets in European countries that have a less favourable political context, infrastructure investments in emerging markets and assets that still carry certain types of construction risk might not qualify for the special infrastructure category under the Solvency II standard formula since they might not fulfil the necessary requirements.*

That said, the majority of our investments into infrastructure are not through special purpose vehicles ('direct investment') but into the listed equity and bonds of infrastructure corporations. We thus stress the importance of bringing infrastructure corporates – in particular those with a large regulated asset base such as transmission system operators – into the special infrastructure asset class. We encourage the European institutions to follow through with the work initiated in this regard.

**Institutions for Occupational Retirement Provision (IORP) Directive**

The IORP Directive represents progress in two central dimensions. The first is that the EU equivalent to the UK concept of fiduciary duty, the prudent person rule, now allows pension funds to consider environmental, social and governance factors. This clarifies the question if the consideration of climate risk is within the remit of fiduciary duty – a discussion that has been creating legal uncertainty especially for pension fund trustees over the last few years.

The IORP Directive also requires pension funds to conduct a comprehensive Own Risk Assessment at least every three years, or following a significant change to the risk profile. The second dimension representing progress is that pension funds in their own risk assessment should consider climate change, use of resources and the environment, social risks and stranded asset risks. Many IIGCC members have already been very active in integrating climate risk into their risk assessments, and we welcome that this is now becoming an industry standard.

**Direct infrastructure investment in emerging markets**

Investors need new financial models for scaling up their green investments in emerging markets:

- Blended public and private capital
- Unbureaucratic models under which to pool smaller projects
- Public partners to provide support against political risk
- Some form of risk sharing

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1 Risk charges determine the amount of capital institutions covered by Solvency II have to hold against the stress-tested liability scenario of a 1 in 200 years’ event. In simplified terms, the combined market value of the amount of capital held against the risks and the value of the assets themselves needs to be sufficient to cover liabilities with a target likelihood of 99.5%.
Direct infrastructure investment in the EU

IIGCC’s position on the European Fund for Strategic Investments (EFSI) was defined in its March 2015 paper setting out 12 fixes to increase EU-wide infrastructure investment (see Box 1). Several of the asks listed in this paper were reflected in the design of the Juncker Plan by European policy-makers and the European Investment Bank, not least the application of the EIB’s fairly robust sustainability criteria which effectively rule out EU support for new high-carbon investment. IIGCC welcomes these developments. Now that the Juncker plan has been set in motion and the main investment vehicle (EFSI) is operational, it is crucial that EFSI’s investment committee steps up its engagement with institutional investors. We would like to mention the very positive role played by the European Investment Bank in catalysing low-carbon investment and engaging the institutional investment community.

Box 1

12 fixes to greatly increase infrastructure investment in Europe through EFSI

1. Ensure the 2030 framework guides all investment support provided under the Investment Plan for Europe and align Energy Union plans with that framework
2. Apply transparent and robust sustainability criteria when selecting all investments
3. Focus on attracting institutional investor capital
4. Focus on project pipeline expansion, including via greater attention to project development and construction-phase projects
5. Ensure the Investment Plan crowds in (and does not crowd out) private sector investment
6. Aggregate infrastructure assets
7. Increase standardisation of contracts and other project documentation; encourage convergence of regulatory environments
8. Ensure an independent and commercially astute investment committee
9. Consider the EU’s role in reducing risk to investors from retroactive policy changes
10. Consider the effect of unintended constraints from financial or competition regulations on investments in low carbon technologies and in climate resilience
11. Develop a powerful industrial strategy for the development of low-carbon infrastructure
12. Promotional banks and national governments should come forward with their own contributions to the EFSI (via promotional banks)

Sustainable CMU action plan

IIGCC also welcomes the intention behind the capital markets union (CMU) action plan to unify capital markets across Europe and remove barriers so that bank financing – which is still constrained by de-leveraging – can be complemented by institutional capital.

It has been demonstrated that the full integration of environmental, social and governance considerations (ESG) into investment processes and decisions contributes to capital preservation as well as to improving long-term risk-adjusted returns. Unfortunately, Commission proposals so far relegate sustainability considerations to niches within the CMU rather than making them a cornerstone.

The Commission intends to review the CMU proposals in due course. IIGCC supports the development of a sustainable CMU action plan as part of this review process.
At a high level, the European Commission should connect the dots between the capital markets union and the 2030 climate-energy policy framework in the same way that it has ensured the European Fund for Strategic Investments will support the 2030 targets. **IIGCC thus supports a high-level commitment to the 2030 targets built into the CMU review.**

*Progress in delivering this high-level commitment should be tracked and accelerated through the European Semester Process*, which should be extended beyond the implementation of the Europe 2020 strategy. The annual growth survey and the iterative process of reviewing national economic and financial policy should encourage greater coherence between the 2030 targets and the CMU.

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**Box 2**

**Explaining the European Semester process**

The European Semester Process is the iterative coordination process for EU economic policy that was developed in order to improve the coherence of economic policy across the European Union, at a time the Eurozone crisis made greater policy coherence essential. The European semester process is initiated by the Annual Growth Survey developed by the Commission, and is built on national reform programs as well as country-specific recommendations that are adopted by the Council of the EU. The European Semester process aims to implement the objectives of the Europe 2020 strategy, of which climate-energy objectives form an important part. The European Semester process could be extended beyond 2020.

We see Solvency II and Basel III/IV as the key European and international initiatives to enable this process. We understand that the European Commission is considering revising the way that the Capital Requirements Directive and Regulation (CRR/CRDIV) (which translated Basel III into European law) is designed. *This offers the opportunity to expand the favourable treatment of financial institutions covered by Solvency II and investing into infrastructure, to banks as well.*

However, the revision of Solvency II and the upcoming revision of the CRR/CRDIV only cover infrastructure investment (the “opportunities side”) and not climate risk. While enhanced investment into sustainable infrastructure assets can be considered to offer an indirect “hedge” against listed equity or bond exposures to corporates or sovereigns negatively affected by the low-carbon transition, it does not of itself improve the way that capital markets assess, price and transfer risks on the side of high-carbon incumbents.

The greater risks inherent in high-carbon assets need to become more transparent. *Climate risk needs to be better integrated into the ratings provided by rating agencies and thus also into the risk charges that financial institutions covered by Solvency II and Basel III have to set aside.* We welcome recent developments in this regard and urge greater uptake of climate risk assessments in mainstream risk assessments.
Disclosure

IIGCC is fully engaged with the Financial Stability Board’s industry-led Task-force on Climate-related Financial Disclosures (TCFD).

IIGCC’s position on climate risk disclosure is set out in its response to the TCFD’s recent consultation (http://www.iigcc.org/publications/publication/iigcc-submission-to-consultation-by-the-task-force-on-climate-related-finan), which was developed jointly with our sister investor networks in the USA (INCR) and Australasia (IGCC).

- IIGCC supports the development of disclosure principles for all parts of the investment chain, from companies to investors themselves.
- Given the nascent status of investor disclosure methodologies, investor disclosure principles should be non-prescriptive and allow for the emergence of best practice.
- So-called ‘2 degrees’ stress testing’ has to become a core part of corporate climate risk disclosure in all of the sectors most affected by climate change.
- Narrative reporting should complement quantified stress-testing. The results should be fed into corporate strategy through a systematic approach to risk management and disclosure.

In order to fulfil the requirements of the Non-Financial Reporting Directive, the European Union is currently developing guidelines of its own that will seek to define (standard) core disclosure elements for all companies. Many industry representatives have suggested that these guidelines should be made as loose as possible. This goes against the G20 trend of having more stringent climate risk disclosure methods. It would also undermine the comparability of disclosures across the EU.

IIGCC supports stringent principles for company climate disclosure across the EU as part of the non-financial reporting directive.

A growing number of EU policy-makers have recently called for pension funds to conduct climate stress-tests. We support this in principle and await the recommendations of the Taskforce on Climate-Related Financial Disclosures in this regard. The ability of pension funds to conduct stress-tests will be contingent in large part upon disclosure of climate risk by underlying companies and by the asset managers with whom pension funds invest, as well as the availability of agreed methodologies and appropriate staff, financial resources and clean data to conduct tests. Some asset owners have started to conduct basic stress-testing of the robustness of strategic asset allocation and economic sector exposures to different climate change scenarios on the back of investment consultant climate risk modelling.

IIGCC believes that mandatory full stress-testing of asset owner’s climate risk exposure would be premature at this time. However, basic stress-testing should be encouraged to the extent currently possible.
Capital mobilisation: Climate-energy policy

European climate-energy policy should be designed with the needs of institutional investors in mind. Asset owners contribute to direct and indirect sustainable infrastructure investment. They are also significantly invested into European utility companies and provide considerable capital for low-carbon technology companies.

In a position paper (June 2015), “Delivering Investment to Implement Europe’s 2030 Climate-Energy Targets” IIGCC spelled out its position on the European Emissions Trading Scheme (EU-ETS). It argues that in order to ensure an orderly transition to a low-carbon economy, continuous incentives for innovation are necessary not only in the power sector, but also for many other parts of European industry. The paper suggests:

- A large number of allowances have not been assigned to their intended recipients, for example because industrial installations closed. These allowances should not flood the market and thereby increase further the surplus in the ETS. Instead they should be placed in the MSR or permanently cancelled.
- IIGCC supports carbon leakage provisions in principle but argues they should be limited to those companies actually at risk.
- IIGCC presents additional recommendations on how to determine who is at risk of carbon leakage and how the modernisation fund should be focussed on sustainable projects.
- The introduction of an emissions performance standard in the event that the reform of the ETS is not projected to lead to sufficient investment early enough to attain the 2030 targets.

In addition, IIGCC cautions that due to the volatility and low price levels of allowances in the EU-ETS, the scheme on its own will fail to incentivise the necessary investment into low-carbon technologies. Rather, the ETS should continue to be coupled with low-carbon support schemes to drive investment, as well as an emissions performance standard which determines when old, inefficient coal plants will be phased out.

IIGCC has also adopted positions for two sectors not covered by the EU-ETS: property and transport.

Property sector

The revision of two EU Directives that govern energy efficiency and the energy performance of buildings provides a vital opportunity to drive radical improvements in Europe’s existing building stock. We support the introduction of a binding goal to bring the entire European buildings sector to a nearly-zero energy standard by 2050. A 2030 target should thus to be as ambitious as possible: at least 30% compared to business as usual.

To deliver this, measures that target new builds should focus on implementing the current framework effectively leading to zero energy standards for new public buildings from 2018 and new commercial buildings by 2020. Regarding the existing building stock, the principle of ‘continuous improvement’ should be used to deepen and strengthen requirements to retrofit of existing buildings. Technology now enables more dynamism: the energy performance framework should transform static (one off) Energy Performance Certificates (EPCs) into dynamic electronic format that records, and more frequently updates, both the design and operational performance of property. Such dynamic EPCs could then become the foundation of an ‘electronic building passport’.

We call on the financial sector and policy makers to work together to implement the recommendations of the Energy Efficiency Financial Institutions Group (EEFIG). To that effect we welcome the proposal for a Smart Finance for Smart Buildings policy paper. The paper should aim to use public funds to leverage private capital; provide greater technical assistance resources for aggregation (including with an easy and quick to use private sector facility) and to carry out more work to clarify energy efficiency investment risks. We suggest that financial regulators could be asked to examine how mortgage affordability assessments and mortgage portfolio stress tests could account for the risk of higher future energy prices, actual and potential energy efficiency levels and the higher property value that can come from lower-carbon buildings.
Transport

IIGCC supports the setting of ambitious long-term decarbonisation goals for the transport sector and encourages the further improvement of motor vehicle testing procedures to ensure they reflect real-driving conditions as closely as possible.

Paris Agreement

IIGCC understands the complexities involved in conducting the ratification process in so many national parliaments. Nevertheless, IIGCC supports early ratification and accession to the Paris Agreement (by the end of 2016) in order to give credit to the EU’s continued climate leadership.

Conclusion

The above recommendations demonstrate the importance of financial regulation as well as climate-energy policy for the low-carbon transition. The cost and benefits of the transition will depend on how effectively financial markets assess, price and transfer risks inherent in the transition to the low-carbon economy and the physical impacts of climate change. Our recommendations, particularly in terms of the appropriate treatment of infrastructure as an asset class under Solvency II and Basel III/IV, should be able to advance the ability of investors to manage their legacy exposure towards high-carbon assets and invest into low-carbon projects and infrastructure corporations. A sustainable CMU action plan should be tracked through the European Semester process for economic policy coordination. Climate-energy policy needs to be enhanced as well in order to mobilise the capital that will then be ready to be deployed into sustainable infrastructure projects and infrastructure corporations.