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2 – PRIVATE FINANCE

Overarching recommendations

- Financial firms, as well as real economy firms, should be expected to create and disclose plans for transition to climate neutrality by 2050 and should disclose progress against these plans annually.
- The ongoing process to develop the taxonomy of sustainable economic activities must continue to be governed independently and built on science-based evidence.
- Expectations on financial firms should be strengthened beyond disclosure, to include integration of material ESG factors and long-term sustainability into investment, lending and insurance decisions.

Private finance is starting to take note of sustainability but investment in risky and unsustainable activities continues.

It has been widely noted that investments which performed well on environmental and social governance criteria outperformed main market indices during the stock market volatility during the first half of 2020. Evidence increasingly shows that this was not a short-term phenomenon and that outperformance can be demonstrated over previous years.[45]

Despite this recent shift in market perceptions, corporate governance practices remain inadequate in their integration of long-term horizons and sustainability in decision-making processes. For example, only 14% of companies in Europe report their board discussing climate issues in their non-financial report, and only 15% report a link between sustainability objectives and executive remuneration while just 18% of boards have oversight of corporate climate-related risks and opportunities.[46]

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[45] ESGClarity (2020) **ESG outperformance begun well before covid downturn**, summarising key findings from research by Morningstar

[46] Alliance for Corporate Transparency (2019) **2019 Research Report**

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This reflects the fact that integrating sustainability issues into investment decisions is not yet a mainstream practice. There is a long way to go to change this situation, although the regulatory context has been changing fast in recent years. In general, there is now more awareness and action for sustainability integration among asset owners and asset managers, with banks and insurers still lagging in their ambition and actions.

Going beyond disclosure to focus on targets and plans

The Sustainable Finance Action Plan committed the European Commission to assess the possible need to require corporate boards to develop and disclose sustainability strategies, including appropriate due diligence throughout the supply chain, and measurable sustainability targets. The development of comprehensive long-term sustainability strategies by companies can have many benefits, including channelling resources towards relevant investments at the firm level and protecting employees and customers.

Now that Europe is moving to putting climate neutrality by 2050 into law it is no longer appropriate for climate transition planning by firms to be a discretionary activity. This risks policy failure due to continued investments in unsustainable activities, and a further build-up of climate-related risk in the financial system. Mark Carney, the UN Envoy on Climate Change and Finance and an advisor to the UK government for COP26, has noted that: "We need the whole economy to transition. Investment professionals are asking 'who is ready', 'who will benefit' and they need common information to compare them."[47]

Expectations should not only be on real economy firms but also on financial sector firms which are taking decisions daily that will shape the future direction of the real economy for decades to come. Several initiatives are in place to support asset managers in disclosing the alignment of their portfolio with the Paris Agreement, e.g. the Institutional Investors Group on Climate Change and the 2° Investing Initiative[48]. Autumn 2020 will see new methodologies emerge, e.g. from the Paris Aligned Investment Initiative[49] and the Science Based Targets Initiative[50].

[47] ESGClarity (2020) **Carney: we need the whole economy to support transition to net zero carbon**

[48] 2Dii and UN PRI (2018) **PACTA**

[49] IIGCC (2019/2020) **Paris Aligned Investment Initiative**

[50] SBTi (2018-20) **Science-based Target Setting Resource for Financial Institutions**

In order to ensure that economic transition occurs at the necessary scale and pace, both financial and non-financial firms should be asked to make and disclose climate transition plans. Plans made by financial firms should relate primarily to financed rather than operational emissions. The European Commission published a study on directors' duties and sustainable corporate governance in July 2020. The study suggested that policy intervention should foster more sustainable corporate governance and contribute to more accountability for companies' sustainable value creation.[51]

Financial firms, as well as real economy firms, should be expected to create and disclose plans for transition to climate neutrality by 2050 and should disclose progress against these plans annually.

- The European Commission should table legislation by mid-2021 to set a mandatory requirement for financial and non-financial firms to develop sustainability strategies and to publish transition plans to achieve science-based targets for climate neutrality by 2050.
- Companies – including financial firms such as banks and insurers as well as asset owners and managers – should be required to develop sustainability strategies, to publish climate transition plans, and to link remuneration of executive staff to achievement of corporate sustainability targets. Strategies, targets and plans should be informed by a materiality assessment process and climate-related scenario analysis.
- The upcoming legislative proposal on sustainable corporate governance should require companies to align shareholder interests with strategic goals and stakeholder accountability. Companies should be required to improve integration of long-term climate and broader ESG risks and impacts at board level.

[51] EY (2020) **Study on directors' duties and sustainable corporate governance**

Ensuring robust due diligence on sustainability

Current due diligence practices are insufficient to foster environmental and human rights risk management. Only a third of companies undertake environmental and human rights due diligence despite the existing voluntary framework.[52] Companies also fail to extend corporate risk assessment processes to those affected by its supply chain. There is also a lack of access to remedies for those affected by corporate environmental and human rights harms of companies.

Asset managers will be required to conduct due diligence on ESG and SRI funds through proposed changes to the Undertakings for the Collective Investment in Transferable Securities Directive (UCITS) and the Alternative Investment Fund Managers Directive (AIFMD). However, mandatory due diligence is also needed among real economy firms, banks and insurance companies.

The European Commission launched a study on due diligence which was published in February 2020.[53] The study indicated a need for policy intervention, a conclusion which was supported by companies and NGOs.[54]

The European Commission should mandate companies to undertake corporate environmental and human rights due diligence.

> An environmental and human rights due diligence legislation should be prepared for real economy companies, banks and insurance companies in 2021, to support enforcement of disclosure requirements.

> Rules should ensure that due diligence processes are developed and conducted with involvement of civil society stakeholders.

> Corporate responsibility should be proportional to the extent of the company's impacts but also its ability to mitigate these impacts. Small and medium-sized enterprises operating in high-risk sectors should still be required to undertake due diligence.

[52] British Standards Institute (2020) **Study on due diligence requirements through the supply chain**

[53] Ibid.

[54] European Commission (2020) **Consultation on the Renewed Sustainable Finance Strategy**

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Strengthening financial and corporate sustainability disclosure

Since 2018, the EU Non-Financial Reporting Directive requires large public interest companies to disclose material information on key environmental, social and governance aspects. However, the European Securities and Markets Authority has assessed that the quality, consistency, comparability and accessibility of sustainability data are inadequate to analyse market developments and assess potential risks to investors.[55] The recommendations of the Task Force on Climate-related Financial Disclosures are referenced only in non-binding guidelines and five years after publication are still followed by few European companies.[56]

Corporate disclosure is a route to supporting European companies in effectively transitioning their businesses towards a resilient net-zero future. Currently, most European companies are not making enough progress. While 82% of companies report on climate change policies, only 36% have a climate change target and just 14% are science-based targets. Only 28% report on the outcomes of their actions taken to address climate change.[57]

Disclosure is also an opportunity for companies to improve their resilience to climate risks. Transition risks and physical risks are currently reported by only 16% and 22% of companies respectively. Just over 20% of companies report on the effects of these risks on their strategies, while fewer than 32% report on risk mitigation strategies. On average, 7% of companies disclose the use of climate-related scenarios to inform their strategies. Only 11% report the risks on their value chains and just 3% report the breakdown of these risks by activity or region.

In the Sustainable Finance Action Plan, the European Commission set out various actions for strengthening sustainability disclosure, including a commitment to reforming the Non-Financial Reporting Directive which resulted in a public consultation in early 2020.[58] The Taxonomy Regulation places complementary reporting requirements on companies falling under the scope of the Non-

[55] European Securities and Markets Authority (2020) **ESMA Report on Trends, Risks and Vulnerabilities**

[56] Climate Disclosure Standards Board (2020) **Falling short? Why environmental and climate-related disclosures under the Non-Financial Reporting Directive must improve**

[57] Alliance for Corporate Transparency (2019) **2019 Research Report**

[58] European Commission (2020) **Non-financial reporting by large companies (updated rules)**

Financial Reporting Directive.[59] The European Commission is also assessing the use of Distributed Ledger Technologies to facilitate the availability of information relevant to investors through the European Financial Transparency Gateway.[60]

The European Commission should ensure that companies report robustly on material sustainability risk issues in their mainstream annual reports.

> The current review of the Non-Financial Reporting Directive should keep 'double materiality' at its core and ensure that companies are required to report all material sustainability-related information in their mainstream report whether this information is defined as material to the company or material to the environment.

> Climate disclosures should be made in line with the recommendations of the Task Force for Climate-related Financial Disclosures.

> Sustainability related disclosures should be subject to the same audit and verification requirements required of financial information, thereby increasing the reliability and rigour of material sustainability information.

The European Commission has consulted on the idea of creating a database of reported corporate sustainability data. This idea would address the issue that data is currently scattered between many annual reports issued in different jurisdictions and languages. However, in the 21st century solving that problem does not require a new reporting mechanism but rather the modernising of existing reporting. If sustainability disclosure is brought up to the same standards as financial disclosure through use of electronic reporting, and use of data tagging, then an open database can be created from existing reported data.

[59] European Parliament and Council of the EU (2020) **Taxonomy Regulation**

[60] **The European Financial Transparency Gateway (EFTG)**

The European Commission should facilitate the collation and presentation of reported corporate sustainability data in an open and freely available database, to facilitate data access by all stakeholders.

> Creation of a new database need not require any additional disclosure by companies if existing reporting requirements are fit for purpose.

> Mainstream reports should be provided to regulators in digital form and sustainability data points should be tagged in accordance with a common methodology (e.g. XBRL) to make them machine readable.

> Reports should be filed with relevant regulators and tagged data should then be pooled at European level to create a central resource for stakeholders.

Integrating sustainability into investment ratings

Sustainable investing assets are growing in Europe.[61] In recent years, ESG ratings have become a widely used tool to support investors in identifying the risks and opportunities related to the sustainability in their investments. S&P Global, Moody's and MSCI have recently made notable acquisitions of leading ESG firms.[62] This creates a risk of market concentration and reduced competition which could increase the cost of access to ESG data and analysis and could hamper future improvements to ESG rating methodologies.

ESG ratings are currently not regulated and there are very few safeguards to ensure quality or consistency. The variability between the ESG data provided by different sustainability providers hampers the comparability and reliability of ESG data, and its consistent use by investors. The largest rating agencies are primarily from the US and the UK which also risks divergence of mainstream practice from priorities that are important within the European Union.

[61] Global Sustainable Investment Alliance (2019) **2018 Global Sustainable Investment Review**

[62] Financial Times (2019) **Credit rating agencies join battle for ESG supremacy**

ESG data from sustainability providers is usually based on information reported by companies. Yet the lack of standardisation and comparability of ESG information currently disclosed by most companies, and its limited availability, hinders effective decision-making by investors. There are several issues with the data currently reported, e.g.

> The availability and quality of information in Central and Eastern Europe is behind compared to the rest of Europe.[63]

> Companies primarily report on their policies rather than on the outcome and impact of these policies, which is inadequate to determine accurately sustainability impacts.[64]

> Companies rarely apply a double materiality perspective to disclosure.[65]

Data issues are compounded by a lack of transparency around the criteria and methodology used in proprietary ESG research, combined with a lack of consistency in research approaches between different research firms.

The variability in ESG ratings from different providers reflects a significant divergence in rating methodologies. Some methodologies allow unsustainable businesses, such as coal and weapon companies, to feature in ESG funds and indexes. In addition, ESG ratings are often based on company policies, the majority of which are not founded on science-based targets. It would be preferable for leading ESG ratings to be set in response to corporate sustainability strategies that are in line with science-based climate and environmental targets, and with specific social goals.

[63] Alliance for Corporate Transparency (2019) **2019 Research Report**

[64] Alliance for Corporate Transparency (2019) **2019 Research Report**

[65] Climate Disclosure Standards Board (2020) **Falling short? Why environmental and climate-related disclosures under the Non-Financial Reporting Directive must improve**

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The European Commission and European Supervisory Authorities should ensure that ESG data, research and ratings meet minimum standards.

> The European Commission should monitor concentration risks in the ESG ratings market and should consider preventing the further concentration of ESG providers in order to allow enough choice between ESG data, research and rating providers.

> The European institutions should monitor market developments to understand the range of offerings available in the market and could consider establishing a European sustainability rating agency which would assess corporate disclosures through the lens of the taxonomy.

> The European Commission should provide ESG data, research and rating providers with a legal status and should require providers to meet minimum standards regarding transparency of their methodologies and sourcing of data, and adequate pricing of services. ESG ratings should be subject to audit and verification requirements.

Maintaining the integrity of the taxonomy

This EU taxonomy will define which activities are classed as 'sustainable' in terms of climate change, environmental and social impacts. The taxonomy will gradually be embedded into law and will be regularly updated and reviewed. It will also underpin classification systems for other areas such as standards, the ecolabel and sustainability benchmarks.

The taxonomy, together with standards and labels for sustainable financial products, constitute a toolbox to support investors to make informed decisions. This should stimulate growth in certified sustainable investments whilst avoiding 'greenwashing' – the practice of overstating environmental impact.

The European Commission is in the process of setting up a Platform on Sustainable Finance which will govern the future development of the taxonomy. Future work will address several key areas:

> The taxonomy does not yet cover all sustainable activities, initial work has focused on climate change mitigation and adaptation. More work will be needed to address other environmental impacts, and social impacts.

> The taxonomy defines sustainable activities but does not yet clearly differentiate unsustainable activities from 'neutral' activities that neither contribute to nor harm sustainability.

> Due to a lack of policy coherence across European files the taxonomy's thresholds for climate change mitigation in the buildings, industry and agriculture sectors are not yet aligned with climate neutrality by 2050:

  > The threshold for building renovation lacks an absolute minimum energy standard target, while the threshold for construction of new buildings is based on the Near-Zero Energy Building (NZEB) which varies between Member States.[66]

  > Industrial activities are evaluated against benchmarks from the Best Available Technologies defined under the EU Emissions Trading Scheme, are not aligned with climate neutrality by 2050.[67]

  > Agricultural activities are evaluated against benchmarks derived from the Common Agricultural Policy (CAP) which is widely criticised as incompatible with climate neutrality by 2050.[68]

The integrity and usefulness of the taxonomy depends on its objectivity and science-based approach. This approach must not become subject to political interference. Future work must be conducted independently of political considerations.

The ongoing process to develop the taxonomy of sustainable economic activities must continue to be governed independently and built on science-based evidence.

> The Taxonomy's Delegated Acts should ensure that the taxonomy continues to be governed independently, remains science-based and is not affected by political considerations.

[66] Agora Energiewende (2020) **Critical review of the potential contribution of the European Commission proposal for an EU Recovery and Resilience Programme and a new Multiannual Financial Framework to achieving the objectives of the Green Deal and the 2030 and 2050 climate targets**

[67] Ibid.

[68] Pe're G. and Lakner S. (2020) **The EU's Common Agricultural Policy Could Be Spent Much More Efficiently to Address Challenges for Farmers, Climate, and Biodiversity**

> The taxonomy should be strengthened for the buildings, industry and agriculture sectors in line with climate neutrality and broadened to cover more sustainable activities.

> Social thresholds should be strengthened and subsequently a social taxonomy should be developed in 2022 with a view to complete by the end of the year.

> An unsustainable taxonomy should be developed in 2022 with a view to complete by the end of the year.

> To create consistent signals across financial markets the European Commission should collaborate with countries that are also developing taxonomies and identify principles for harmonisation while retaining a science-based approach.

Aligning investor disclosures with the taxonomy

A Regulation on Sustainability Disclosures in the Financial Sector was adopted in 2019 and requires institutional investors to make a wide range of disclosures about how they consider and integrate sustainability in their investment decisions.[69]

In April 2020 the European Supervisory Agencies published a joint consultation paper on their proposed regulatory technical standards[70] which contains a substantial list of proposed metrics to be reported against. As the taxonomy is still only partially developed, some of these metrics address areas not yet defined by the taxonomy. It will be important to ensure that taxonomy development and investor disclosure do not diverge.

The European Commission and European Supervisory Authorities should ensure that taxonomy development and investor disclosure rules do not diverge.

[69] Official Journal of the European Union (2019) **Regulation (EU) 2019/2088 of the European Parliament and of the Council**

[70] European Banking Authority (2020) **Joint Consultation Paper on ESG Disclosures Standards for Financial Markets Participants**

- The taxonomy and investor disclosure requirements should be aligned so that the principal adverse indicators proposed for investor disclosure explicitly map to the taxonomy's Do No Harm criteria for environmental objectives and minimum social safeguards.
- In the short term this could be achieved by moving to principle-based reporting through either a removal of mandatory principle adverse impacts metrics entirely or, alternatively, selection of a shorter list of the most well-established issues and metrics to report on.
- In either case, the stringency of the requirements could be maintained by an increasing focus on requirements for investment managers to disclose how principle adverse impacts are being identified and what actions are being taken to mitigate them.

Incentivising long-term shareholder engagement by institutional investors

In the Sustainable Finance Action Plan, the European Commission asked the European Supervisory Agencies to collect evidence of undue short-term pressure from the financial sector on corporations and consider further steps. The European Supervisory Agencies delivered their reports in December 2019.[71] The studies found evidence of short-termism in the financial sector.

Institutional shareholders manage large sums of capital on behalf of citizens and thus have a potentially large influence over listed companies. However, asset managers do not necessarily retain holdings on a long-term basis. Unless instructed to do so by asset owners they have limited incentives to improve the long-term performance and sustainability of investee companies.

The Shareholder Rights Directive II introduces transparency requirements to better align long-term interests between asset owners and asset managers with

[71] European Securities and Markets Authority (2019) **Undue short-term pressure on corporates**; European Banking Authority (2019) **EBA Report on undue short-term pressure from the financial sector on corporations**; European Insurance and Occupational Pensions Authority (2019) **Potential undue short-term pressure from financial markets on corporates: Investigation on European insurance and occupational pension sectors**

regards to shareholder engagement.[72] However, the Shareholder Rights Directive applies solely to equity investments, while the alignment of an investment strategy with the time horizon of beneficiaries should be applicable to all asset classes. Some countries have set out national stewardship codes, such as the UK and the Netherlands, but this practice remains rare at the national level. Individual investors can still have difficulty to engage with companies they have invested in, for example due to practical issues with cross-border voting. [73]

The European Commission should enhance long-term shareholder engagement between institutional investors and investee companies.

> The EU framework for the Shareholder Rights Directive should clarify the rights and obligations of shareholders and improve the conditions for individual shareholders to actively participate in company decision-making processes by strengthening shareholder voting mechanisms and reducing thresholds for tabling shareholder resolutions.

> Institutional investors should be required to disclose how they implement their investment and engagement policies in all asset classes, including consideration of sustainability factors, and to engage with investee companies to seek to improve their long-term performance and sustainability. This should be mainstreamed through national stewardship codes and subsequently by instituting an EU stewardship code.

> Institutional investors should also be obliged to produce reports explaining how their actions in corporate governance best serve the company and their clients.

> Long-term investment could be further incentivised by linking voting rights and reduced dividend taxation to the duration of shareholding.

Strengthening fiduciary duties for asset managers and pension providers

Several pieces of EU legislation require institutional investors and asset managers to act in the best interest of their beneficiaries. This is commonly

[72] European Parliament and Council of the European Union (2017) **Shareholder Rights Directive II**
[73] EuroFinuse (2012) **Barriers to shareholders engagement: report on cross-border voting**

referred to as 'fiduciary duty'. The European Parliament adopted the Disclosure Regulation in early March 2019 under the Sustainable Finance Action Plan, requiring asset managers to disclose how they consider sustainability factors in their risk and decision-making processes. Anticipating the stricter standards, some European asset managers – particularly in France and Germany – reported lower sustainable asset values in 2018.[74]

Asset managers will also be required to conduct due diligence on ESG and SRI funds through proposed changes to the Undertakings for the Collective Investment in Transferable Securities Directive (UCITS) and the Alternative Investment Fund Managers Directive (AIFMD).

However, the original intent of the European Commission to address systemic factors and risks in the investment decisions process has not been taken forward. Among 33 of Europe's largest asset managers who cooperated with a WWF study in 2018, none had aligned their equity and bond portfolios with a low carbon trajectory across all climate-relevant asset classes.[75]

Instead the regulation focused on increasing transparency and disclosure of investors' duties towards end-investors. The fiduciary duty of institutional investors and asset managers is not clearly legislated to enforce the consideration of sustainability factors and risks in the mainstream investment process.

[74] Global Sustainable Investment Alliance (2019) **2018 Global Sustainable Investment Review**

[75] WWF (2018) **European Asset Owners: Climate Alignment of Public Equity and Corporate Bond Portfolios**

The European Commission should clarify fiduciary duties for asset managers to set a clear expectation that they will integrate material ESG factors and long-term sustainability into all investment decisions.

> Expectations should ensure the alignment of investment horizons with those of clients and beneficiaries and should ensure appropriate consideration of sustainability risks within that timeframe.

> Requirements on asset managers should ensure that they have a solid understanding of the preferences of their clients, including ESG factors, and that they provide clear information to their clients about the potential benefits and risks including the effect on the prospective return of the investment strategy.

> The financial and non-financial interests of end-investors should be transmitted throughout the investment chain by guiding the extension of mandates from asset owners to asset managers and other intermediaries.

Pension providers' long-term investment policies make their assets potentially more exposed to long-term risks compared with other financial institutions. To demonstrate the scale of the potential risks involved, a stress test of Institutions for Occupational Retirement Provision (IORPs) conducted in 2019 by the European Insurance and Occupational Pensions Authority wiped out €270 billion or almost a quarter of investments.[76]

Sustainability reporting and ESG integration by EU pension providers were taken up by the IORP II Directive in 2016 and private voluntary plans for personal pensions under the PEPP Regulation in 2017.

In late 2019 a report by a high-level group of experts on pensions recommended that the EU and Member States further clarify how pension providers can take into account the impact of Environmental, Social and Governance (ESG) factors on investment decisions and develop cost-effective tools and methodologies to assess the vulnerability of EU pension providers to long-term sustainability risks.[77] The European Insurance and Occupational Pensions Authority issued

[76] EIOPA (2019) **Occupational Pensions Stress Test 2019**
[77] High-Level Group of Experts on Pensions (2019 **Final Report of the High-level Group of Experts on Pensions**

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an opinion in 2019 recommending further action by pension provides to take account of ESG issues.[78] The European Commission will review the IORP II Directive by January 2023 and report on its effectiveness.[79]

The European Commission should strengthen fiduciary duties for pension providers to explicitly include integration of sustainability into investment decisions.

> Integration and disclosure of sustainability impacts by pension providers to clients and regulators should be made mandatory and should be based on agreed science-based criteria and forward-looking scenario analysis.

> Pension providers should be encouraged to instruct asset managers actively to engage with companies in order to reduce sustainability impacts and improve sustainability outcomes.

> End-investors, including occupational pension beneficiaries and policyholders should be consulted about their sustainability-related preferences.

> As long-term investors, pension funds should be encouraged to invest in new sustainable infrastructure. The EU can potentially support this through creating incentives for such investments and by taking supportive measures to reduce risk perception (e.g. first-loss public investment).

[78] EIOPA (2019) **Opinion on the supervision of the management of environmental, social and governance risks faced by IORPs**

[79] European Commission (2020) **Consultation on the Renewed Sustainable Finance Strategy**