



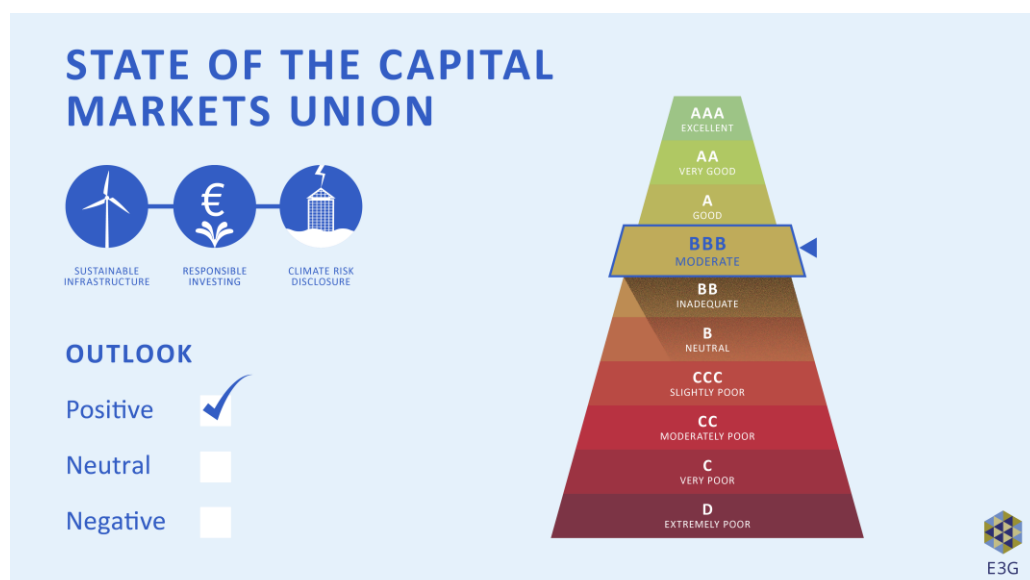
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BRIEFING PAPER DECEMBER 2017

THE STATE OF THE CAPITAL MARKETS UNION TWO YEARS ON, HAS IT DELIVERED ON SUSTAINABILITY?

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In October 2015, the European Commission launched its Capital Markets Union (CMU) initiative. It was set up to provide new sources of funding for business, help increase options for savers and make the economy more resilient. To deliver this overarching ambition, the CMU has five sub-objectives. One of these is to ensure “an appropriate regulatory environment for long term, sustainable investment and financing of Europe’s infrastructure”¹. Two years on from the CMU’s launch, this briefing paper assesses progress made over the past year in delivering this objective.



¹ European Commission (2015) **Action Plan on Building a Capital Markets Union**



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The briefing paper assesses the progress made in delivering sustainable investment through the CMU by scoring progress made against what E3G regards as the core principles necessary to achieve this. They are: delivering sustainable infrastructure; supporting sustainable development; and improving understanding of climate and other environmental, social and governance (ESG)-related risks. The CMU is given an updated 'credit rating' based on the actions taken so far and those planned during final 18-20 months of this initiative.

Last year, E3G gave the CMU a 'BB' rating for sustainability². It was concluded that the focus on delivery of the sustainability objectives had been inadequate and that additional policies would be required to boost sustainable investment.

This year the score is improved. The CMU is given a 'BBB' rating reflecting three important changes:

- Eurostat (the Statistical Office of European Commission) published an updated guidance note setting out how to record energy performance contracts (EPCs) in national accounts³. This guidance removes the requirement to record EPCs in national accounts where the private sector provides financing and takes on the operational and financial risk.
- The European Commission has taken a first step to integrate sustainable finance considerations into financial supervision through the proposals to strengthening the powers of the European Supervisory Authorities (ESAs)⁴. The proposals specifically require the ESAs to take into account ESG factors arising within the framework of their mandate.
- The European Commission launched a public consultation on institutional investors' and asset managers' duties regarding sustainability⁵. This is a direct response to a recommendation of the High-Level Expert Group on sustainable finance (HLEG)⁶ that investors have an obligation to include considerations of sustainability as part of their duty to their beneficiaries and clients.

It is E3G's view that there is more work to be done. Two important opportunities have been missed – regarding the integration of sustainability considerations into the proposal to amend the Capital Requirements Directive and Regulation ('CRD-IV package')⁷ and the proposal for a pan-European pension product (PEPP)⁸.

²E3G (2016) [The State of the Capital Markets Union](#)

³European Commission (2017) Eurostat Guidance Note - [Recording of energy performance contracts in government accounts](#)

⁴European Commission (2017) [Communication on reinforcing integrated supervision to strengthen Capital Markets Union and financial integration in a changing environment](#). Proposal for a Regulation COM(2017)536

⁵European Commission (2017) Directorate-General for Financial Stability, Financial Services and Capital Markets Union - [Consultation document 'Institutional investors and asset managers' duties regarding sustainability'](#)

⁶European Commission (2017) [High-Level Expert Group on Sustainable Finance Interim Report](#)

⁷European Commission (2016) [Proposal for Regulation amending Regulation \(EU\) No 575/2013 and amending Regulation \(EU\) No 648/2012](#)

⁸European Commission (2017) [Proposal for a Regulation on a pan-European Personal Pension Product \(PEPP\)](#)



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That said, the CMU as it currently stands has been awarded a ‘positive’ outlook. This is based on the fact the European Commission stated in its Mid-Term Review of the Capital Markets Union Action Plan⁹ (CMU Mid-Term Review) it will:

- Decide, by Q1 2018, on the concrete follow up to the HLEG’s recommendations.
- Set in motion work to prepare measures to improve disclosure and better integrate sustainability/ESG in rating methodologies and supervisory processes, as well as in the investment mandates of institutional investors and asset managers.
- Develop an approach for taking sustainability considerations into account in upcoming legislative reviews of financial legislation.
- Report on whether the accounting treatment of equity instruments in IFRS 9 is sufficiently conducive to long term financing by Q2 2018.
- Amend the prudential treatment of private equity and privately placed debt in Solvency II by Q3 2018.
- Assess the drivers of equity investments by insurance companies and pension funds by Q4 2018.

These commitments have the potential to create a step change in shifting the European economy onto a more sustainable footing through a deep re-engineering of the financial system that places sustainability considerations at its core.

The remainder of this paper is structured as follows. The first section sets out the three principles against which the CMU is assessed. These were developed in conjunction with a wide range of Non-Governmental Organisations, think tanks, academics and investors working on sustainable finance¹⁰. The following sections look at each of the principles in turn and updates E3G’s assessment of progress made in the last year to delivering these objectives.

⁹European Commission (2017) **Mid-Term Review of the Capital Markets Union Action Plan**

¹⁰E3G would like to acknowledge the following organisations for their contribution: 2 Degrees Investing Initiative, Action Aid, Ario Advisory, Aviva, Cambridge Institute for Sustainability Leadership, Carbon Tracker Initiative, CDP, Climate Disclosure Standards Board, ClientEarth, Climate Bonds Initiative, Climate Disclosure Standards Board, Eurosif, FERN, Finance Watch, Frank Bold, Friends of the Earth Europe, Global Witness, Hermes, Institutional Investor Group on Climate Change, Impax, Mirova, Preventable Surprises, Rainforest Action Network, Schroders, ShareAction, SOMO, Smith School Stranded Assets Programme, Tomorrow’s Company, UNEP-FI, WHEB and WWF.



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1. Principles for a Sustainable Capital Markets Union

1a. Investment in sustainable infrastructure should be sufficient to ensure future prosperity

Infrastructure is the backbone of the economy. Well-designed infrastructure projects have significant economic benefits: they provide jobs, boost productivity and are essential for sustainable development. Much of Europe's existing infrastructure is coming to the end of its productive life, but current investment levels are too low for it to be replaced by the sustainable infrastructure needed to deliver a low carbon and climate resilient economy¹¹. To do this, private sector capital will be required. As such, the new strategy for sustainable finance should include reforms that help close current shortfalls in investment – estimated to be €180bn per year for the decarbonisation of the EU economy¹² and €435bn per year across all infrastructure¹³.



1b. The financial system should support sustainable and inclusive development

The global economy faces substantial threats from environmental and social factors including climate change, water scarcity and inequality. All financial institutions, and especially those that invest for the long-term, should be required to explicitly consider financially material ESG factors in their investment decisions. Doing so will start to correct the market failures caused by short-termism and contribute to more efficient capital allocations. Going further, policies should be implemented that encourage the mainstreaming of responsible investment practices. In doing so, these measures can help the EU meet its obligations under both the Paris Agreement and the UN Sustainable Development Goals.



1c. Financial market participants should understand climate-related risks

The financial sector increasingly recognises the risks and opportunities inherent in a changing climate. Nevertheless, the quality of disclosures of climate-related information is poor and inconsistent¹⁴. This lack of information risks the mispricing and inefficient allocation of capital in relation to climate risk. The resulting potential for large and abrupt corrections in asset values could threaten financial stability¹⁵. Improving corporate and financial institution understanding of these risks – as the FSB's Taskforce for Climate-related Financial Disclosures (TCFD) set out to do – is one step toward ensuring these risks are considered. Better disclosures will also improve the quality of information investors have as they consider ESG factors, which could help accelerate the mainstreaming of responsible investment strategies.

¹¹European Investment Bank (2016) [Restoring EU competitiveness](#)

¹²European Commission (2017) [High-Level Expert Group on Sustainable Finance Interim Report](#)

¹³European Investment Bank (2016) [Restoring EU competitiveness](#)

¹⁴Disclosures made in statutory filings are mostly poor or non-existent, while separate disclosures (for example through voluntary initiatives such as CDP, or in corporate sustainability reports) may contain more information but still may not help investors to understand what is material.

¹⁵Task Force on Climate-related Financial Disclosures (2017) [Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures](#)



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2. Investment in sustainable infrastructure should be sufficient to ensure future prosperity

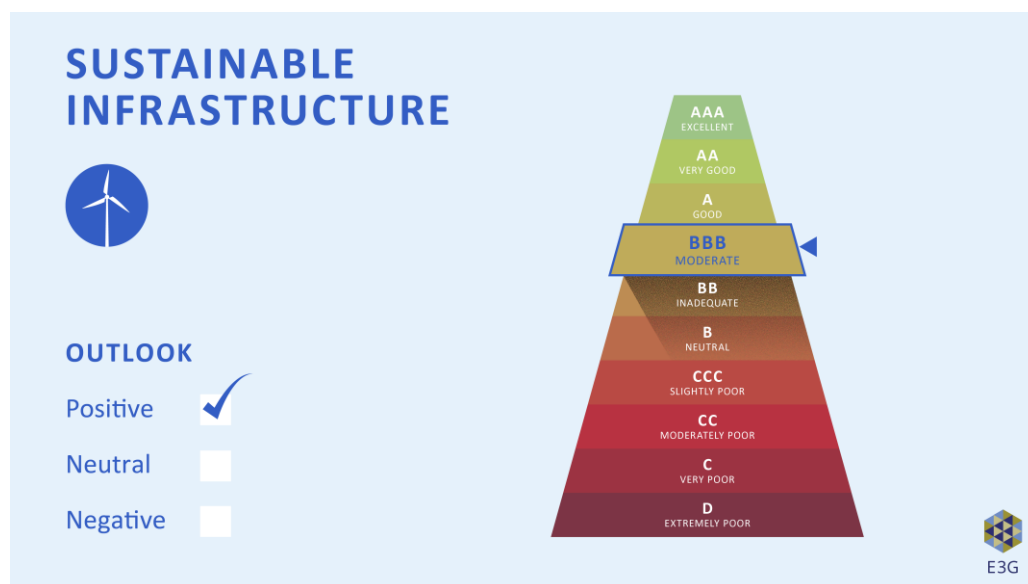


2a. Actions two years on

Since E3G’s last assessment, the European Commission has introduced one new measure to support the goal of mobilising investment towards sustainable infrastructure. In its CMU Mid-Term Review, the European Commission proposed to **amend the Solvency II Delegated Regulation on infrastructure corporates**¹⁶, lowering the risk calibrations for insurers’ investments in infrastructure corporates. This builds on previous proposals to revise prudential regulation for European Long-Term Investment Funds¹⁷ and securitisation products¹⁸. Looking ahead, the European Commission will also amend the prudential treatment of private equity and privately placed debt in Solvency II¹⁹.

Four further actions announced by the European Commission in 2016 have been progressed in the past year. These are set out below.

In November 2016, the European Commission published its proposal to amend the existing **Capital Requirements Directive and Regulation** (the ‘CRD-IV package’)²⁰, including measures to create a more risk-sensitive regulatory environment to promote high-quality infrastructure projects and reduce risks for investors. The European Parliament and Council of the European Union (Council) are currently scrutinising proposals and are expected to reach an agreement by the beginning of 2018.



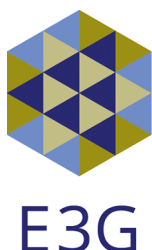
¹⁶Proposal amending **Delegated Regulation (EU) 2015/35 for infrastructure corporates**

¹⁷Amendments to Solvency II legislation regarding infrastructure projects and ELTIFs took effect in April 2016 – Official Journal of the European Union (2016) **Commission Delegated Regulation (EU) 2016/467**

¹⁸European Commission press release (30.05.2017) **Capital Markets Union: EU reaches agreement on reviving securitisation**

¹⁹See European Commission website (20.11.2017) **Actions as set out in the mid-term review of June 2017**

²⁰European Commission (2016) **Proposal for a Regulation amending so-called CRD IV package**



Also in November 2016 the European Commission published its **study on the potential of green bonds** to meet the EU's investment needs in²¹. However, it has yet to follow up with concrete actions.

In September 2017, Eurostat (the Statistical Office of European Commission) published an **updated guidance note setting out how to record EPCs in national accounts**²². This is outside the remit of CMU but relevant to delivery of its objectives. Until this year Eurostat's guidance on the interpretation of IFRS (International Financial Reporting Standard) rules relating to EPCs required these investments to appear on the public sector's balance sheet, even though the private sector provides financing and takes on the operational and financial risk.

The amendment is a technical yet significant alteration. The interpretation of accounting rules has been reported as one of the main drivers of under-investment in energy efficiency²³. The changes will make it easier for schools, hospitals, and other public buildings - which make up more than 10% of the EU's overall building stock²⁴ – to invest in energy efficiency.

As of October 2017, the **European Fund for Strategic Investment (EFSI)** has continued to invest into strategic infrastructure as well as into research and development and small and medium-sized enterprises and has mobilised €240 billion in public and private capital²⁵. However, this falls far short of the infrastructure investment needed to deliver a sustainable European economy.

The European Commission's proposal to create EFSI 2.0, which extends the fund's duration to 2020 and its size to €500bn is still awaiting approval by the European Parliament and Council. The fate of the European Commission's proposal to require at least 40% of the funds will be used for climate action is still not known.

2b. Future plans

In its CMU Mid-Term Review the European Commission set out three key measures that could substantively increase investment into sustainable infrastructure. These were European Commission will report by June 2018 on whether a review of **accounting treatment of equity instruments in IFRS 9** is actively blocking equity investment and long-term debt provision. The European Commission will also **assess the drivers of equity investments by insurance companies and pension funds** by end of 2018.

Finally, a very important action set out in the CMU Mid-Term Review was the confirmation that the European Commission will **decide on the concrete follow-up it will give to the recommendations of the HLEG** by the end of March 2018. This is a positive assurance that the European Commission is actively seeking to integrate

²¹European Commission (2016) **Study on the potential of green bond finance for resource-efficient investments**

²²European Commission website (20.10.2017) News - **Changes to Eurostat rules to boost investment in energy efficiency**

²³Energy Efficiency Financial Institutions Group (2015) **Energy Efficiency – the first fuel for the EU Economy**

²⁴European Commission website (20.10.2017) News - **Changes to Eurostat rules to boost investment in energy efficiency**

²⁵European Commission website (19.10.2017) News – **'Juncker Plan now set to trigger more than €240 billion'**



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sustainability into the EU's regulatory and financial policy framework. The HLEG recommendations in the interim report which are relevant to promote long-term investment in sustainable infrastructure are the **creation of a classification system for sustainable assets, a European standard and label for sustainable assets (including green bonds) and the creation of the 'Sustainable Infrastructure Europe' facility.**

2c. Assessment

A range of actions have been taken to try to boost investment in sustainable infrastructure in the EU, but progress is slow so a 'BBB' rating is awarded, unchanged from last year, as these actions continue in the right direction but will likely be insufficient. A major step change in sustainable infrastructure investments is unlikely from these actions as they currently stand.

The European Commission's fresh attempt to increase the appetite of institutional investors to invest in infrastructure assets through further **amendments in Solvency II** is welcomed. Infrastructure corporates are very important as a large proportion of infrastructure investments are in listed equity and bonds of infrastructure corporations²⁶. Similarly, the changes to the **CRD-IV package** to make it easier for banks to support high-quality infrastructure projects is a positive move to increase investments in the real economy. However, both proposals - as with previous alterations to Solvency II - fail to differentiate between investments in low-carbon, climate resilient infrastructure and that of high-carbon infrastructure. This is a missed opportunity to ensure investments made now do not become stranded assets in the future. For capital requirements for banks, the HLEG has recommended including a brown-penalising factor which raises the capital requirements for sectors with stronger sustainability risk, capturing the risk of sudden value loss due to stranded assets.

Going forward E3G recommends that, at the very least, ESG criteria should be incorporated in the CRD-IV package. The revision of the Institutions for Occupational Retirement Provision (IORPs) Directive - which requires occupational pensions institutions to integrate risks "*related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ('stranded assets')*" into their risk management system²⁷ and tri-annual risk assessments^{28, 29} - is one model that could be used to achieve this. Integrating sustainability criterion in this way would reduce the risks of banks making loans to infrastructure projects which are likely to become stranded in the near future.

²⁶PWC/GIIA (2017) **Global infrastructure Investment** - 50% of global infrastructure investment (equity and PPP) is through corporates

²⁷ Official Journal of the European Union (2016) **IORPS II Directive** Article 25

²⁸ Official Journal of the European Union (2016) **IORPS II Directive** Article 28 The pensions institutions are also obliged to conduct a risk assessment at least every 3 years covering, where applicable, risks relating to climate change, use of resources and the environment, social risks and stranded asset risks. Going forward with the IORPs Directive, it will be up to Member States, in the transposition of the Directive, to demand explicit disclosures of ESG factors by occupational pensions institutions in investment decisions and their risk management systems. Member states will instruct how ESG risks are factored the risk assessment, in a manner they judge as proportionate to the size, nature, scale and complexity of the institution

²⁹ShareAction (2017) **Institutions for Occupational Retirement (IORPs) Directive - Significant Progress on Responsible Investment**



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The **EFSI** continues to mobilise capital to build more sustainable infrastructure in the EU. Nevertheless, investments in high carbon projects continue and some key priorities like energy efficiency have received little attention. E3G analysis shows that of the total invested, high carbon investments fell to 11% during the period between July 2016 and October 2017^{30,31}. This is positive, but more should be done to refocus attention on building a pipeline of sustainable infrastructure projects.

Here the HLEG's recommendation of creating a **'Sustainable Infrastructure Europe'** facility to accelerate the development and financing of sustainable infrastructure projects to meet investor demand and deliver the EU's sustainable policy objectives would be a welcome next step. In the interim it is also noted that European Commission and European Investment Bank have launched a new initiative, called "Urban Investment Support", which will help cities plan investments to support their own urban development strategies and get easier access to finance³². Similarly, HLEG's recommendations – as set out in the interim report – to create a **classification system for sustainable assets**, as well as the establishment of a European **standard** for these assets will be key to build trust in the market for sustainable financial products.

Resolving how to unlock the capacity of **insurance companies and pension funds** to invest in equity should be a priority in 2018.

³⁰The first scorecard in 2016 analysed EFSI investments in the Infrastructure and Innovation Window between March 2015 and July 2016. This scorecard analysed investments between July 2016 and October 2017.

³¹This reduction is mainly due to the decline of investments in high carbon transport projects made during this period - likely to be an early reaction to the proposed changes to the EFSI regulation which includes a general prohibition on investments in motorways. European Commission (2016) **EFSI 2.0 proposal** – "EFSI support to motorways should be avoided, unless it is needed to support private investment in transport in cohesion countries or in cross-border transport projects"

³²European Commission press release (28.11.2017) **Commission and European Investment Bank launch new advisory service to help cities plan investments**



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3. The financial system should support sustainable and inclusive development



3a. Actions two years on

Since E3G’s last assessment, the European Commission has proposed one new measure to recalibrate the financial system to support sustainable and inclusive development. In November 2017, it launched a public consultation on **institutional investors' and asset managers' duties regarding sustainability**³³. This was in direct response to one of the key recommendations set out in the HLEG’s interim report. The European Commission also started work on an impact assessment to gauge how the integration of sustainability into investor duties could contribute to a more efficient allocation of capital as well as to sustainable and inclusive growth.

In addition, three further actions announced by the European Commission in 2016 have been progressed in the past year.

In October 2016, results of the European Commission’s Directorate General for Justice and Consumers **consultation on long-term and sustainable investment** were published³⁴. To date there has been no formal follow up to the consultation, but the results act as a useful resource since they put on record a range of investor views on how barriers to long-term sustainable investment can be addressed. They also demonstrate industry support for a range of sustainable finance reforms including to address issues with short-termism, fiduciary duty, disclosure shortcomings and Solvency II and CRD-IV rules.



³³European Commission (2017) Directorate-General for Financial Stability, Financial Services and Capital Markets Union - **Consultation document 'Institutional investors and asset managers' duties regarding sustainability'**

³⁴European Commission (2016) DG for Justice and Consumers - **Summary of the responses to the public consultations on Long-term and sustainable investment**



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In December 2016, the final text of the **IORP II Directive** was published in the Official Journal of the European Union³⁵. As a result of the agreement between institutions, pension funds will have to consider ESG risks in their investment decisions and document this in their three-yearly statement of investment policy principles³⁶.

Finally, in June 2017, the European Commission issued a proposal looking at fostering long-term retail investment. The proposal for **regulation on a pan-European Personal Pension Product (PEPP)** aims to foster long-term retail investment by offering consumers more choice to save for retirement³⁷. The regulation as currently drafted does not integrate sustainability factors. This is a significant missed opportunity but one that can and should be addressed in dialogue with the European Parliament and Council.

3b. Future plans

In its CMU Mid-Term Review the European Commission set as a priority action the need to develop an approach for **taking sustainability considerations into account in upcoming reviews of financial legislation**. The HLEG has proposed that this can be achieved by introducing a new 'sustainability test' - a practical tool to measure the performance of EU legislation against sustainability criteria. This should be a core proposal the European Commission commits to take forward in 2018.

3c. Assessment

The European Commission's decision to take steps to clarify the responsibilities of investors to manage long-term sustainability risks as part of their duty to their beneficiaries and clients is extremely positive. It is however disappointing that this action is counteracted by the lack of consideration for sustainability in the PEPP proposal. Therefore, a rating of 'B' is given as the two policies are likely to have a neutral impact overall.

As the European Commission develops its response to the current **consultation and impact assessment on investor's duties**³⁸ it should take care to ensure it covers all the key participants in the investment and lending chain. In addition, in terms of setting out how to integrate sustainability considerations into investors duties, a harmonised approach to covering all the relevant participants, taking into account for example the role of the ESAs – discussed in the next section, will be needed.

As noted the failure to integrate sustainability considerations into the **PEPP** proposal, is a missed opportunity. This is especially surprising since PEPP providers are expected

³⁵Official Journal of the European Union (2016) **IORPS II Directive**

³⁶European Commission press release (30.06.2017) **Commission welcomes deal to improve rules for occupational pensions** - The revision of the IORPs (Institutions for Occupational Retirement Provision) Directive requires occupational pensions institutions to integrate risks "related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ('stranded assets')" into their risk management system (Article 25) and tri-annual risk assessments(Article 28).

³⁷European Commission (2017) **Proposal for a Regulation 2017/0143 on a pan-European Personal Pension Product (PEPP)**

³⁸European Commission (2017) Consultation - **Institutional investors and asset managers' duties regarding sustainability**



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to focus on long-term investment, matching the long-term liabilities of the pension product. This should be addressed in the trialogue process. One means to do this would be to include an explicit requirement for PEPP providers to integrate material ESG considerations in their risk management processes^{39,40}.

Finally, the European Commission's statement in its CMU Mid-Term Review of the need to develop an approach for **taking sustainability considerations into account in upcoming reviews of financial legislation** and HLEG's forthcoming proposals for a **sustainability test** could prove instrumental in reorienting the financial system to support sustainable and inclusive development.

On this basis the outlook for responsible investing in the EU is awarded a 'positive' status.

³⁹ShareAction (2017) **A Pan-European Personal Pension Product Fit for a Sustainable Europe**

⁴⁰European Commission (2017) **Proposal for a Regulation 2017/0143 on a pan-European Personal Pension Product (PEPP)**



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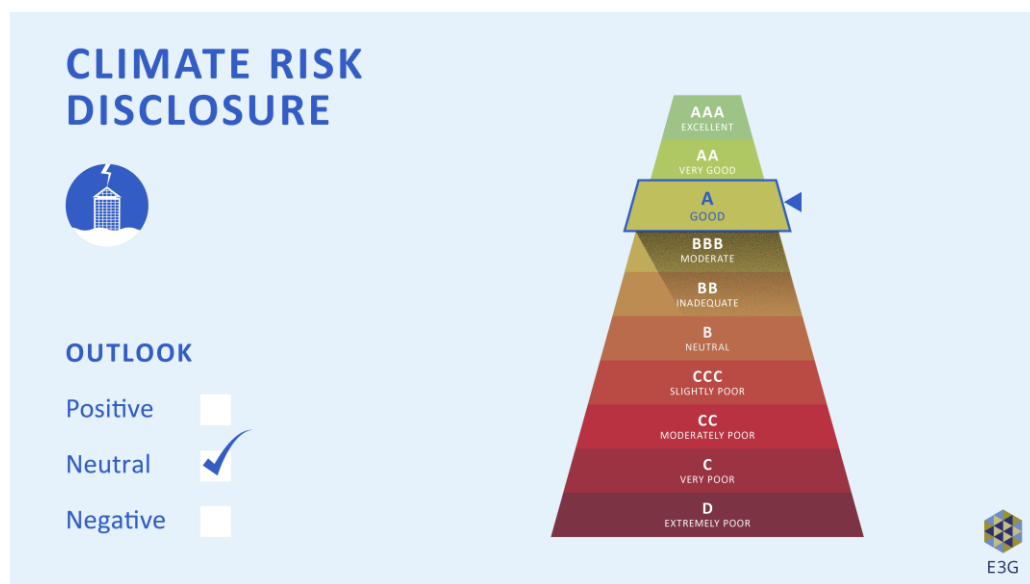
4. Financial market participants should understand climate related risks



4a. Actions two years on

Since E3G’s last assessment, the European Commission has introduced one new measure to improve the understanding of climate-related risks in the financial system. In September 2017, the European Commission announced proposed **reforms to the EU’s supervisory architecture**⁴¹. These include strengthening the powers of the ESAs and promoting an explicit focus on promoting sustainable finance, stating “The ESAs will promote sustainable finance, while ensuring financial stability. They will take account of environmental, social and governance-related factors and risks in all the tasks they perform”⁴². The proposals – including the main Regulation and the subsequent changes to a number of sectorial Directives – will now be discussed by the European Parliament and the Council. The HLEG’s final recommendations should provide useful guidance to the European Commission on how best to achieve this.

Two further actions announced by the European Commission in 2016 have been progressed in the past year.



⁴¹European Commission (2017) **Proposal for a regulation - COM(2017)536**

⁴²European Commission press release (20.09.2017) **Creating a stronger and more integrated European financial supervision for the Capital Markets Union** and



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In June 2017 the procedure to revise the rules for publishing prospectuses was finalised with the adoption of the **Prospectus Regulation**⁴³. The final regulation recognises that “environmental, social and governance circumstances can constitute specific and material risks [...] and, in that case, should be disclosed”⁴⁴. Regarding the disclosure of risk factors, the European Securities and Markets Authorities (ESMA) will develop guidelines to assist competent authorities on the specificity and materiality of risk factors to be included in prospectuses⁴⁵.

Also in June 2017, the European Commission published **non-binding guidelines on the disclosure of non-financial information** by companies⁴⁶. The aim of the guidelines is to help companies disclose relevant and useful information on environmental and social matters – including relating to climate-related risks. As noted in E3G’s last briefing, this is useful, but only to a limited extent. The guidelines are unlikely to be useful for companies that are trying to provide a Non-Financial Report tailored to the needs of investors.

4b. Future plans

In its CMU Mid-Term Review the European Commission committed to set in motion work to prepare **measures to improve disclosure and better integrate sustainability/ESG in rating methodologies and supervisory processes**. This has in part been actioned through the review of the ESAs yet no plans have been proposed which set to improve the specific nature of ESG reporting requirements across all financial products, financial assets, financial institutions, and financial authorities. Improved disclosures were also a key area identified in the HLEG’s interim report. The forthcoming final recommendations of the HLEG should provide guidance on how to take this forward in 2018.

4c. Assessment

Significant progress has been made during 2017 and therefore an ‘A’ rating is awarded.

Enhancing the role of the **ESAs** in assessing ESG risks is very welcome and is vital to secure the long-term stability of Europe’s financial sector⁴⁷. Clarity is now needed on the specific actions the ESAs should adopt to integrate sustainability into all their tasks. For example, ESMA - in relation to the **Prospectus Regulation** - should build on the positive language on ESG risks in the final Regulation⁴⁸ and include requirements for issuers to report on specific and material climate and wider sustainability risks through the development of prospectus guidelines. In addition to this, the HLEG’s final report should provide some useful guidance on how to integrate sustainability into the tasks of the ESAs.

⁴³Official Journal of the European Union (2017) **Prospectus Regulation 2017/1129**

⁴⁴Official Journal of the European Union (2017) **Prospectus Regulation 2017/1129** Recital 54. This text was introduced during interinstitutional negotiations, having been originally proposed by the Council - **Interinstitutional File**

⁴⁵Official Journal of the European Union (2017) **Prospectus Regulation 2017/1129** Article 16 – Risk factors

⁴⁶Official Journal of the European Union (2017) Communication from the Commission - **Guidelines on non-financial reporting**

⁴⁷E3G (2017) **The role of ESMA in Sustainable Finance**

⁴⁸Official Journal of the European Union (2017) **Prospectus Regulation 2017/1129** Recital 54



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In the European Commission's **Non-Financial Reporting guidelines**, there is specific reference and support for the work of the TCFD. This is important for the development of the disclosures of financially material climate-related information. Yet, there is a need to move beyond the current separation of mainstream financial reports and non-financial reports. The Non-Financial Reporting Directive (NFRD) will require no more than *non-financial* climate change information (the impact of companies behaviour on the environment/society) in comparison to the climate-related *financial information* (the risks to companies from climate change) highlighted in the recommendations of the TCFD. The latter is the information demanded by investors in order to measure and respond to climate change risks. The European Commission should therefore propose specific amendments to the Accounting Directive⁴⁹. The disclosure of this information will be to the benefit of millions of EU citizens' savings and pensions, and the overall stability of the financial system^{50,51,52}.

Improving ESG reporting requirements was a part of the priority action outlined in the CMU Mid-Term Review to strengthen the EU's leadership on sustainable investment. Undertaking the reforms, such as to the Accounting Directive, set out above would help fulfil this objective. As the HLEG's interim report notes, the current lack of relevant disclosure by firms and financial institutions makes it difficult for managers, investors and other stakeholders to analyse ESG-related risks and opportunities. They conclude that recent TCFD recommendations should be integrated into a EU framework to help firms and financial institutions improve their ESG disclosures in a way that advances EU leadership.

Looking beyond disclosure by firms and financial institutions, the European Commission should encourage and support EU stock exchanges and credit rating agencies to improve the disclosure of material and high-quality ESG information as they play essential roles in the investment and lending chain. For exchanges, this should include work with the International Organization of Securities Commissions (IOSCO) to improve ESG information in the global marketplace. For rating agencies, the European Commission should require all credit rating agencies to disclose how they consider TCFD-related information in their credit ratings and ESMA will play an important role here.

An outlook rating of 'neutral' has been given as the European Commission's next steps on ESG disclosure is uncertain. It is imperative that the ESA review is accompanied by plans to improve the specific nature of ESG reporting requirements, moving beyond solely reporting on ESG factors in the NFRD. Only then will have this enable investors to have the quality of information needed to accelerate the mainstreaming of responsible investment strategies.

⁴⁹Official Journal of the European Union (2013) **Accounting Directive 2013/34**

⁵⁰E3G (2017) Letter to Vice-President Dombrovskis - **Aligning the Non-financial reporting guidelines and the FSB Task Force on Climate-related Financial Disclosure's recommendations**

⁵¹Task Force on Climate-related Financial Disclosures (2017) **Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures**

⁵²Official Journal of the European Union (2017) **Guidelines on non-financial reporting**



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Annex: Credit rating methodology

The three principles that the European Commission's CMU actions are being rated against have been designed by E3G and incorporate the views of a wide range of institutions about the aspects of sustainability that are most relevant for capital markets. We have drawn on a wide range of work including that of the UNFCCC and the Paris Agreement on climate change, the UN Sustainable Development Goals, UNEP-FI and the FSB's Taskforce for Climate-related Financial Disclosures.

The overall 'credit rating' reflects our assessment of how the actions and communications from the European Commission line up with the three principles for a sustainable CMU. The ratings for each of the three principles have been combined into an overall rating. The rating consists of two parts: the letter dimension (e.g. AAA), which reflects how actions already taken by the European Commission line up with our principles, and the outlook (positive/neutral/negative), which reflects our assessment of the likely direction of travel, based on future plans from the European Commission.

As with a conventional credit rating, the scale runs from AAA (the highest rating) to D (the lowest). The table below defines each rating.

Rating		Description
AAA	Excellent	The European Commission has or will implement policies that are fully consistent with the principles and are likely to be sufficient.
AA	Very good	A 'AA' rating differs only slightly from the 'AAA' rating – either the principles is not fully met or may not be sufficient.
A	Good	The European Commission has or will implement policies that largely comply with the principles and may not be sufficient.
BBB	Moderate	The European Commission has or will implement policies that somewhat comply with the principles but are unlikely to be sufficient.
BB	Inadequate	The European Commission has or will implement policies that somewhat comply with the principles but are highly unlikely to be sufficient.
B	Neutral	The European Commission has not implemented and isn't in the process of implementing, any policies related to the principles. Or, the European Commission has, or will, implement a range of policies that are likely to have a neutral or negligible overall impact.
CCC	Slightly poor	The European Commission has implemented, or is in the process of implementing, policies that, overall, run somewhat against the principles but are likely to have a small impact.
CC	Moderately poor	The European Commission has or will implement policies that run somewhat against the principles and may have a significant impact.
C	Very poor	The European Commission has or will implement policies that run against the principles and may have a significant impact
D	Extremely poor	The European Commission has or will implement policies that run against the principles and are will have a significant harm.



E3G

About E3G

E3G is an independent climate change think tank operating to accelerate the global transition to a low carbon economy. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere. In 2016, E3G was ranked the number one environmental think tank in the UK.

More information is available at www.e3g.org

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