<u>EESC DRAFT OPINION ON SUSTAINABLE FINANCE ACTION PLAN</u>

0. Introduction: moving towards the new scenario

The accelerated rise in financialization or financial depth of the economies began in 1971 when the US abandoned the dollar-gold standard and money became more fiduciary and intangible, dependent on trust, and soared in the eighties. Until then, the money supply (M2) represented around 50% of the global GDP, similar to financial derivatives.

By the end of the 1980s, the financial assets-GDP ratio was 200%, at the beginning of the 2007 crisis, it reached 400% and derivatives almost 1.000%. After falling during the crisis this amount recovered the previous levels in 2015, multiplying financial assets by 4 to the monetary mass measured by the M2 and derivatives by over 10.

This imbalance between the real and financial economy is ever growing with FinTech and InsurTech´s recent emergence which requires greater efforts for sound regulation and supervision to ensure financial stability.

The 17 UN 2030 Sustainable Development Goals (SDGs) and the Paris Agreement to adapt and build resilience to climate change, should ensure stability recovery and a better balance between inclusive societies and prosperous economies.

In accordance with the EU Treaties vocation, and the subsequent policies carried out, the transition to a low-carbon, more resource-efficient and circular economy are key to ensuring the EU´s **long-term competitiveness,** but also integrating balanced economic, social and governance dimensions.

Indeed, the European response to **2030 Agenda** needs to comply with our treaties and recover a long-term vision of sustainability in which economic growth, social cohesion and environmental protection go hand in hand and support each other.

Facilitating the transition to a sustainable economy now requires understanding that currently financial power attends a strategy of convergence with the even more transformative power of digital technologies and innovations.

Sustainability challenges need sufficient, stable and committed capital, both financial and intangible (human, technological and other forms of relational capital, including that provided by institutions).

Adapting public policies, stimulating private actors, and complementing budget resources is necessary if the EU intends to develop truly sustainable growth, fostering more **transparency a**nd **long-termism** in the economy.

A sustainable vision requires a closer and holistic connection with concrete policies such as the Union of Energy, the Digital Agenda and the Pillar of Social Rights.

Such thinking is also at the core of the EU's Capital Markets Union (CMU) project and the EESC shares the opinion that private capital, EFSI funding and other EU funds should be combined in an efficient manner to shift investments towards those companies that show positive social and environmental externalities.

It´s time to act! Europe has been in the vanguard of sustainability for the past twenty-eight years, but it is by no means alone.

1. Finance for a more sustainable world

We are increasingly faced with the catastrophic and unpredictable consequences of climate change and resource depletion. However, social problems such as inclusion or inequality, whose consequences are also unpredictable, should concern us at the same time.

The EESC stresses that **sustainable finance** should refer to environmental, social and governance dimensions in a balanced, global and comprehensive way, establishing **minimum cross-cut conditions** that cannot be inter compensated. This minimum impassable threshold is set by the International Conventions on **vulnerable population´s rights** (such as women and girls; children; refugees and migrant workers; the disabled, etc.) and by respecting the relevant **good fiscal governance**.

A long-termism approach for sustainable finance should be accompanied by a **longer-term strategy** and a sound **predictability** of overall industrial policy, sector by sector, and must be assured by the EC in order for this process to be feasible and coherent.

The EESC agrees with Commission that a well interconnected and transparent financial system is a prerequisite for sustainable finance. This is a strong reason to consider in parallel with **updating and upgrading Europe's disclosure rules** to make non-financial risks and its associated opportunities fully transparent.

The EESC also welcomes and encourages private disclosure initiatives that promote easily accessible information on sustainable finance.

Considering the sound evidence of european citizens´ appreciation for social and environmental objectives related to their savings and investments, they must be **empowered and connected** with sustainable finance issues.

To this end, a sustainable financial system should be **transparent, factual and understandable** to EU citizens. Improving **access to information** on sustainability performance and promoting **financial literacy** are essential elements.

2. Reorienting capital flows towards a more sustainable economy

Since the EFSI was created, it has mobilised private investment in strategically important EU projects and has been managed according to the European Investment Bank´s (EIB) list of projects (investments in environmental energy and resource efficiency, water, digital sectors, transport, etc).

However, greater projection is needed in other sectors, especially those focused on infrastructures and social institutions that empower the capitals of young people, women and other excluded or vulnerable social sectors.

In the EESC´s opinion, **EFSI** funding should be increased by incorporating capital from EU member States´ financial agencies and public banks, acting as a network to jointly design a more strategic and inclusive long-term perspective, following a common definition on what is sustainable as well as sketching a transitional road map to decarbonize companies.

At the same time, **conditionality** linked to **ECB monetary provisions** should examine a Green and Social interest rate to encourage low-carbon investment. In addition, the European social infrastructure must be rebuilt by developing productive tasks for society that imply social improvements, thus resulting in important savings for public administrations.

2.1. A unified classification system for sustainable activities (UCSSA)

The traditional calculation methods and impact evaluation must be re-examined. More reliable quantitative and qualitative I**ndicator redefinitions** must be established that reconcile the priority economic and ecological values with those of society and humanity´s survival.

The EESC agrees with the EC on the urgency of activating the first stage to build a robust but dynamic "**Sustainable Finance Taxonomy**", to ensure market consistency and clear guidance about what is green, social and related to good governance. Even only starting with climate change, the **holistic approach** must be assured.

A technical Expert Group on sustainable finance is the backbone of this process and is indeed very welcome, as long as participation of **all relevant sustainability stakeholders is ensured.** Legislative initiative would then enable building a robust and credible **green and social taxonomy**, including a "Sustainable financing brand".

This group´s mandate should start with clear objectives in terms of content and timings, being the first step to **reunite the new UCSSA with the other existing international classifications (economic activities, occupations, studies, etc.)**, in order to converge around the UN criteria and references.

This European **taxonomy should include three levels:** 1. a minimum standard aligned with ODS 2030 and the Paris Agreement and the do-no-harm principle in accordance with ESG risk analysis; 2. an intermediate level identifying activities that are demonstrably achieving a 'Positive Impact' as defined by the

UNEP FI; 3. a level including activities that can accelerate positive transformation and support ecological, economic and social regeneration.

The taxonomy of sustainable financial activities must recognize the urgent need to classify profit forms and sanction those that are harmful and undermine citizens´ confidence in the financial and economic system. They must also correctly classify and sanction these practices´ instruments that affect financial and market confidence.

2.2. Standards and labels for sustainable financial products

To facilitate investors´ easier and safe access is paramount to expanding sustainable financial markets. European sustainable finance **standards** should be **carefully configured**.

To this end, current green bonds would be strengthened by introducing an **official EU Green Bond Standard** (EU GBS) and considering an EU Green Bond label or certificate.

In the context of the "**Consumers Financial Services Action Plan**: Better Products, More Choice", the ESSC recommends[1] that the Commission define **additional easily comparable and completely transparent products**, which are simple and have the same characteristics, alongside the consumer products already set out in the action plan.

Indeed, this opens up the possibility of offering "**Flagship pan-European sustainable products**" accompanied by providing appropriate, independent, obligatorily certified **comparison tools**[2] for different **sustainable financial products** in the various EU legal jurisdictions.

The current configuration concerning 'Pan-European Personal Pensions Products' **(PEPP)**[3] require pension providers to disclose publicly whether and how they include ESG factors in their risk management systems, but these provisions **do not oblige** them to take ESG factors into account in their investment policies.

Including this obligation in all products linked to pensions would help to **extend its use as one of the sustainability solutions to current problematic *pay-as-you-go* scheme**, which leads to the trend of lower employment intensity due to population aging and digitalization processes in the making.

2.3. Fostering investment in sustainable projects

[1] See the EESC opinion on Consumer financial services

[2] Based in the "Key principles for comparison tools"

[3] Assets in funded and private pension arrangements exceeded USD 38 trillion in the OECD area at the end of 2016. Funded and private pension arrangements continued to expand in countries such as Australia, Canada, Denmark and the Netherlands, where pension assets exceeded the size of the GDP

According to the **renewed industrial policy strategic objectives**, re-orienting capital allocation towards long-term investments should be aligned with **encouraging sustainable innovation**; e.g. aiding SMEs to grow, supporting less developed regions, upgrading infrastructure, and empowering people through education and training.

Concerning the challenge of completing sustainable infrastructure investment, a larger **macro-prudential policy** observing **physical impacts** (increasingly exposed to climate change-related risks) is needed. For instance, construction codes minimizing natural catastrophe´s impact would require insurance companies to **recalibrate risk management** according to new principles of **sustainable insurance**.

The EESC strongly supports the reinforcement of EFSI 2.0, EFSD, and another strategic public fund that can also direct finance towards the most suitable destination, combining public and private financial sources.

Finally, the EESC recommends to better identify **where** existing public institutions and initiatives achieve maximum sustainable and resilient infrastructure and to replicate them according to **at-scale solutions**.

The EESC welcomes the Commission to take measures to improve the efficiency and impact of instruments aimed at sustainable investment support in the EU and partner countries.

2.4 Sustainability considerations in financial advice

The EESC encourages amending the MIFID II Directive and the Insurance Distribution Directive (IDD), declaring it **mandatory for advisers** to ask clients about **sustainability preferences** linked to their investments. Hence, advisors can exercise appropriate recommendations on financial products.

The EESC supports the Commission on inviting the European Securities Markets Authority (ESMA) to include sustainability provision preferences in its suitability assessment guidelines.

2.5 Sustainability benchmarks

A **common methodology** to measure the non-financial performance of sustainable investment is an optimum goal. In the meantime, the EESC welcomes **harmonising benchmarks** initiatives comprising low-carbon issuers, considering it as a first step that should be extended to other sustainability parameters.

For this reason, the EESC invites the Commission to extend the focus to the social field amongst the technical experts group responsible for consulting all interested parties and publishing a report on the design and methodology of the benchmark index in carbon for the second quarter of 2019.

3. Mainstreaming sustainability into risk management

Sustainability addresses the set of risks associated with wealth generation and cannot avoid the impact of extraction, acquisition and deterioration of resources.

3.1. Sustainability in market research and credit ratings

The EESC has insisted that **rating agencies** must be **free of all conflict of interest** in order to guarantee **research/scoring providers´ independence**. Furthermore, transparent and timely justification of its methodology, case by case, is needed.

Existing credit-rating agencies don´t integrate the influence of disruptive ESG trends in issuers' future credit-worthiness. The EESC calls for clear EU **standards and supervision** regarding the **integration of ESG factors** in ratings for all credit-rating agencies operating in the EU. It also calls for establishing an accreditation process for a 'Green Finance Mark' by ESMA certified agents.

3.2. Institutional investors' and asset managers' sustainability duties

Fiduciary duty

The institutions of the European Union must guarantee strict compliance with **the functions of services or financial intermediation** in its three main sectoral dimensions (economic, environmental and social equity.

This requires a more holistic and strategic approach than planned in the Commission's Action Plan, giving priority attention to relationships in the educational, factorial, gender, geographical, racial or ethnic, religious, cultural or other diversity fields.

The duty of regulators, investors, asset managers, workers and advisors must act in the best interest of the beneficiary (future pensioners) or the client (retail or institutional investors). All their governance engagement and voting activities must be directed towards protecting the sustainable value of investment assets, in line with fiduciary duties. They must report on how they use the voting rights recognised as fund assets.

By clarifying the duties of investors in relation to sustainable factors such as pension funds, insurance companies and asset managers, the EU can encourage a **greater focus on sustainability** issues over the long term (sustainable finance is axiomatically linked to long termism).

3.3. Prudential requirements for banks and insurance companies

EESC has recently emphasised "the potential role that banks can play in the fight against climate change and the application of 13 of the 17 SDGs, through their intermediation functions between conscious savings and socially responsible investment (SRI). (…) and is recommending that capital requirements for banking obtain more favourable treatment for investments in the green economy and various long-term non-complex "**inclusive lending**" operations, such as mortgages, particularly those linked to energy efficiency, installation of solar panels, etc. (…) and consider the application of **capital surcharges** for investments in the **"brown" economy**. The SSM should exercise specific supervision in this matter."[4].

Along those lines it´s necessary to better define the perimeters of the so called "**Green supporting factor**", assuring enough evidence before its implementation. **Responsible Research and Innovation** (RRI), in the H2020 framework, could be an excellent channel for obtaining scientific results.

In summary, this new scenario requires a sound combination of financial risk management with non-financial risks, taking into account externalities´ effects, and adapting rules accordingly in a dynamic process.

4. Fostering transparency and long-termism

The key to solving the sustainable finance riddle is to create an information and incentive framework that redirects capital flows towards necessary investments ensuring a rapid and fair ecological and social transition for Europe, maintaining its leading position in strong values while giving European businesses a competitive advantage.

4.1. Disclosure and accounting

The EESC notes that the EU Directive on disclosure of Non-Financial Information, transposed with low ambition and disharmonized methodology, only affecting big corporations, thus barely contributing to balanced and comprehensive European sustainable investment.

Therefore, the EESC deems it essential to revise the **NFI Directive**, considering all before mentioned key concerns (digital transformation, new metrics, standardisation, compulsory duties, new sustainable economic models, etc.), and is welcoming the announced public consultation on this subject.

The EESC also supports European Parliament´s resolution on International **Financial Reporting Standard (IFRS)** and is urgently demanding an impact assessment of IFRSs on sustainable investments.

The EESC welcomes EFRAG duties to assess the impact of new or revised IFRSs on sustainable investments and to explore potential alternative

[4] See EESC opinion on Completing the Banking Union

accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments.

The EESC also suggests that the Commission invite ESMA to:

- Assess current practices in the credit rating market by Q2 2019, analysing the extent to which environmental, social and governance considerations are taken into account;
- Include environmental and social sustainability information in its guidelines on disclosure for credit rating agencies by Q2 2019 and consider additional guidelines or measures, where necessary.

4.2. Corporate governance and undue capital market short-termism

With regard to governance, many investors would like to know if a company uses accurate and transparent accounting methods, and if that common stockholders are allowed to vote on important issues. They also want companies to avoid conflicts of interest in their choice of board members, rating agencies and auditors.

It´s time to seriously consider not only the **E** and **S** factor (standards, labels, green and social supporting factor for prudential requirements, sustainability benchmarks), but also the **G** factor, excluding all benefits and removing the sustainable rankings to those companies that are avoiding **a transparent disclosure** of key aspects, such as **fiscal governance**, **human rights** corruption, money laundering and other illicit activities.

5. Action Plan implementation

The EESC strongly calls for **aligning** all implicated European **institutions and mechanisms**, if necessary, changing its mandates in accordance with action plan timing implementation.

6. The key missing part: The role of European Supervisory Authorities

Uncertainty on future risks, the lack of long term risk disclosure and the adaptive capacity of companies are key constraints for analyst time horizon (indeed, only a few analyst estimates are covering more than 5 years).

For improving the still poor **scientific methodology to analyse the non-financial risks impacts** in a long-term perspective, more ambitious efforts are needed. Enhancing Responsible Research and Innovation **(RRI)** in the H2020 framework, could allow significant progress in this field.

The **European Supervisory Authorities** should also play a relevant role in monitoring sustainability and giving it coherence. To achieve a common EU methodology for relevant scenario analysis considering ESG risk factors in a longer perspective could be explored and the European Systemic Risk Board (ESRB) should gradually incorporate them in the **stress-testing**.