EUROPEAN COMMISSION
Directorate-General for Justice and Consumers

Brussels, October 2016

JUST/A3

SUMMARY

OF THE RESPONSES TO THE PUBLIC CONSULTATION ON

Long-term and sustainable investment

1. EXECUTIVE SUMMARY

In December 2015 the services of the European Commission launched a public consultation on long-term and sustainable investment. The objective of the public consultation was to gather information on how institutional investors, asset managers and other service providers in the investment chain factor in environmental, social and governance (ESG) information and performance of companies or assets into investment decisions, and what are the possible obstacles to long-term, sustainable investment. This consultation was launched in the context of aspects relevant for the Capital Markets Union.

91 replies were received. These came from a broad variety of respondents including institutional investors, asset managers and their respective associations which altogether provided more than half of the responses, as well as NGOs, public authorities, business federations and other service providers such as a credit rating agency, auditors and investment research providers in a large number of Member States. The replies were substantive and provided a wide overview of the issues in question.

This feedback statement provides a factual summary of the contributions received by question. The public consultation and this statement do not prejudge any position or decision that the Commission might take in the future.

The consultation showed that although the large majority of respondents of different categories were very aware of the importance of ESG matters in investment decisions, they recognised that ESG issues were not sufficiently taken into account and that the quality and depth of ESG integration varied highly among investors. While the situation was improving, the majority of respondents from different groups acknowledged that financial markets still focus predominantly on short term. This appeared to be a systemic problem to which various, different but often interlinked factors contributed. In this respect, several issues were identified:

- It was stressed that when investment decisions are made in a short-term time-frame, investors do not consider the majority of ESG issues financially material. Given that some ESG risks are currently considered as externalities and are difficult to model or value in financial terms, many respondents, particularly investors, called for more innovative risk approaches that attribute a financial value to ESG and externalities. A significant number of respondents, particularly investors, pointed to a reliance on backward-looking analysis of purely financial factors when deciding about future investments and argued that developing proper methodologies to integrate future risks into investment risk models appear to be a challenge.
- The large majority of contributors, in particular institutional investors and NGOs, argued that fiduciary duty i.e. the duty of investors and asset managers to act in the best interest of the beneficiary (i.e. future pensioners) or the client (i.e. retail or institutional investors) was not clear enough and could therefore be used as an excuse for not considering ESG matters in investment decisions.
- Many responses showed that incentives used in the investment chain (asset managers, brokers and investment consultants) were rather short-term focussed. Despite institutional investors' liabilities which often run over decades, their asset managers' performance evaluation and remuneration is predominantly short-term. Although respondents reported that institutional investors increasingly looked at ESG performance when selecting asset managers, many respondents from all sides stressed that ESG considerations were not sufficiently integrated in asset management mandates and into the remuneration of asset

managers.

- Many respondents (particularly investors, NGOs and a respondent from trade union side) considered that internal governance arrangements of institutional investors should be better aligned with the interests of beneficiaries (i.e. future pensioners and insurance policy holders) and thus contribute to an increased focus on long-term risks and opportunities. It was reported that beneficiaries were not provided with a sufficient level of information on ESG strategies and impacts and that the level of involvement of beneficiaries in investors' internal governance arrangements (through dialogue, representation in the board, etc.) was in general very low. In addition, in respondents' view ESG considerations were not at all or only to a very limited extent integrated into the remuneration of the board members of institutional investors.
- The majority of respondents, in particular institutional investors, considered that EU financial regulation did not always fit with the specificities of long-term investment. Many expressed criticism about prudential frameworks, especially Solvency II, and accounting rules for investors which discourage a long-term approach. They explained that prudential rules requiring a level of capital proportional to the level of risk operated in one-year horizon and only took financial risk into consideration for the calculation of capital requirements. Some also considered liquidity requirements as a disincentive to invest into illiquid assets. According to some respondents, the obligation to value assets at market price (mark-to-market) forces investors to sell assets at times of falling prices without due regard to their fundamental characteristics.
- The vast majority of respondents, in particular investors and NGOs, were of the view that it was difficult to obtain appropriate ESG information for investment decisions. The main problem was not the availability of information, but the lack of its reliability, comparability and quality. The majority of respondents found that corporate accountability for ESG disclosure was not sufficient.
- The majority of respondents from all sides were of the view that although a growing number of specialised service providers offered specific ESG research, mainstream equity and credit research were still predominantly short-term oriented. The majority of respondents argued that ESG was rarely integrated into mainstream investment research by brokers, analysts and investment banks. Furthermore, it was insufficiently integrated by traditional credit rating agencies in their ratings and insufficiently considered by the investment consultants who assisted institutional investors in their selection of asset managers. Respondents pointed to barriers such as lack of demand from investors, backward looking methodologies of rating agencies, conflicts of interests and a lack of proper definitions and sector-wide quality standards.

Overall, the consultation appears to show that the markets do not sufficiently internalize ESG risks and respond to ESG opportunities. Many contributors underlined that the transition to "mainstream" sustainable investment needs to be appropriately supported and called for actions to resolve the problems described above.

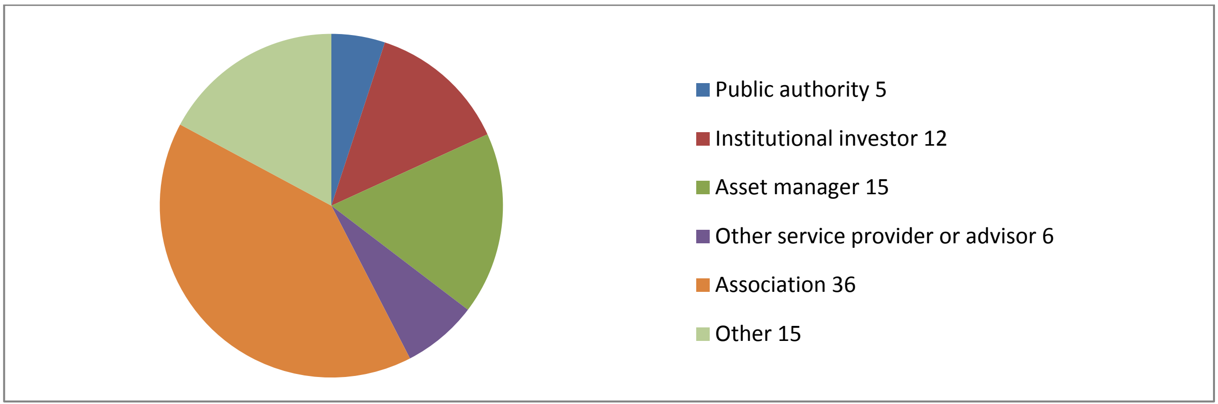
2. GENERAL OVERVIEW

91 replies were received[1]. The replies were substantive and provided an in-depth overview of the issues in question. The large majority of answers came from institutional investors (pension funds, insurance companies and banks) and asset managers as well as their

[1] Two responses have not been included in the statistics because they provided general positions without giving replies to specific questions.

respective associations. In addition, several NGOs, some public authorities, few professional associations (actuaries, accountants), think tanks, business federations as well as other service providers, such as credit rating agency, auditors and investment research providers also provided their views. The European trade unions umbrella organisation (ETUC) also contributed. The chart 1 below provides an overview of all categories of respondents.

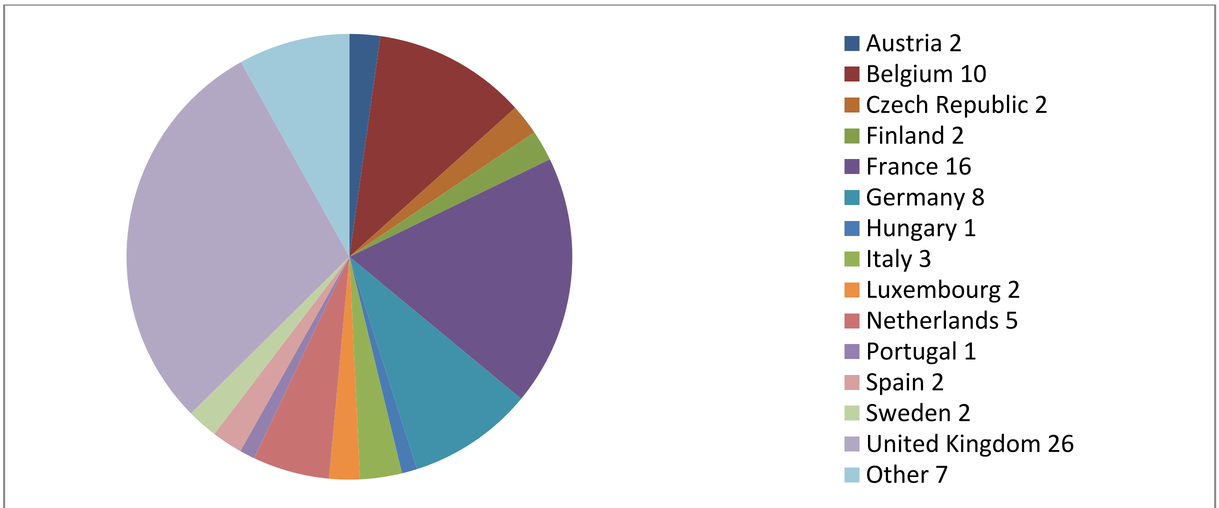
Chart 1 Overview of respondents



The category 'associations' consists of investor and asset manager associations, business federations and NGOs. It includes most major European investor umbrella associations (Pensions Europe, Insurance Europe, EFAMA and Invest Europe). Within this category, most of the replies came from investor associations. Given the heterogeneity of this category, the feedback statement uses instead the following categories of respondents: "investors" reflecting both the views of individual investors and investors associations, "investors associations", "business federations" and "NGOs".

As to the geographical distribution shown in chart 2 below, most responses came from the UK (29%), France (18%), Belgium (11%, including EU and international associations), Germany (9%) and the Netherlands (6%). These are among the main pension and insurance markets in the EU.

Chart 2 Geographical distribution of the respondents



This feedback statement provides a factual summary of the contributions. Where the summary of responses does not distinguish between different categories of respondents, it means that there was no clear differentiation of views between these different categories.

3. SUMMARY OF RESPONSES

Question 1a
Do ESG factors play a role in the investment decisions of investors? If not, why? If yes, please specify which considerations are reflecting in your investment policy and mandates? In what form is this commitment expressed?

Overall, a large majority of respondents acknowledged that the importance of ESG factors in investment decisions had been growing in recent years, which was also reflected by the growing number of signatories to the Principles of Responsible Investment. However, in particular NGOs but also many investors considered that ESG factors were not yet sufficiently taken into account and that the quality of Responsible Investment policies and the depth of ESG integration in investment decisions varied highly among investors. Institutional investors, asset managers and their associations (referred to later on as "investors") confirmed that ESG factors played a role in their decision-making process although to different degrees depending on the investor.

A common element in the investors' replies was that ESG considerations were key for long-term value creation and better long-term return. According to a large investor association and an NGO this was particularly true for large investors, whose investment performance is representative of the performance of capital markets as a whole as well as of the growth of the broader economy ("universal owners"). However, some investors and NGOs explained that ESG was still often regarded more as a risk to be mitigated, than as a positive driver of investment performance and that there was more sustainable investment in statements than in practice.

Respondents referred to research to support these arguments. For example, an asset manager pointed to a research of about 660 institutional investors[2] at global level showing that although 94% of institutional investors surveyed indicated that they had used ESG data, for 64% of these investors inclusion of ESG criteria remained a mere communication tool. The survey also showed that only 34% of the investors considered that they use ESG data in an appropriate and efficient way. A trade union considered that for most institutional investors, maximization of short-term financial returns continued to be the predominant consideration as shown by a survey of 200+ institutional investors[3] indicating that non-financial information played a fundamental role only for 24% of the surveyed investors.

While the consideration of ESG issues depends on the investment strategy of the investor (e.g. investors with a socially responsible approach, investors with a specific mandate from clients to consider ESG factors, investors that integrate ESG factors for risk management purposes), investors reported about a variety of ways in which they approached ESG issues. The most common ESG strategies referred to were exclusion strategies and ESG integration in the investment process, including picking the best performers or engagement on ESG issues with companies. Although impact investing as a separate strategy –where funds are invested with the specific aim of creating a positive social impact - is still in its early stages, it was also reported to be growing.

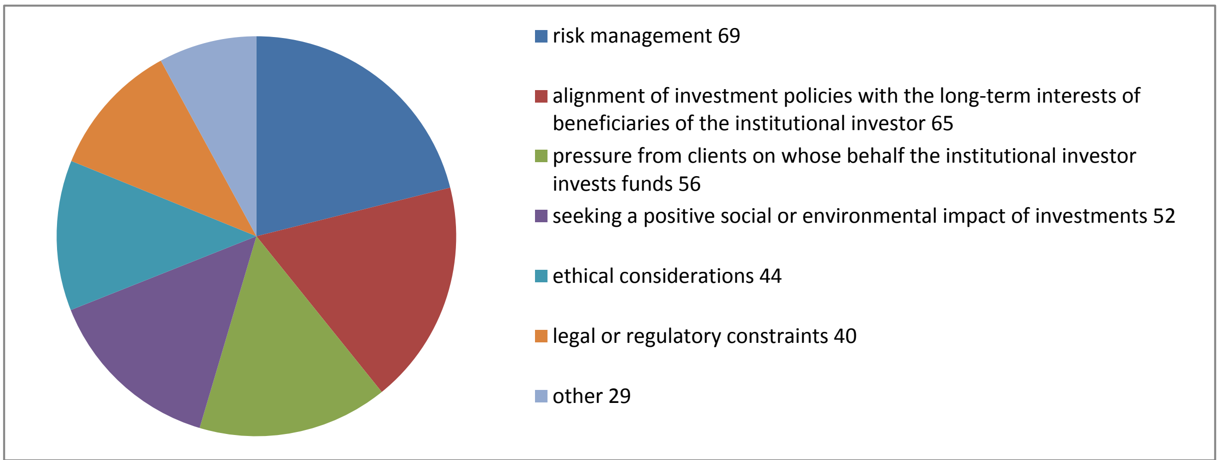
[2] Natixis Global Asset Management's annual survey
[3] Ernst & Young, 2015

Question 1b
What is the main rationale for institutional investors and asset managers to take ESG risks and opportunities into account in their investment decisions? Please indicate all the relevant issues.

Among all respondents, risk management and alignment of investment policies with the long-term interests of beneficiaries were the main rationale for considering ESG risks and opportunities in the investment decisions, followed by pressure from clients and seeking a positive social or environmental impact of investments.

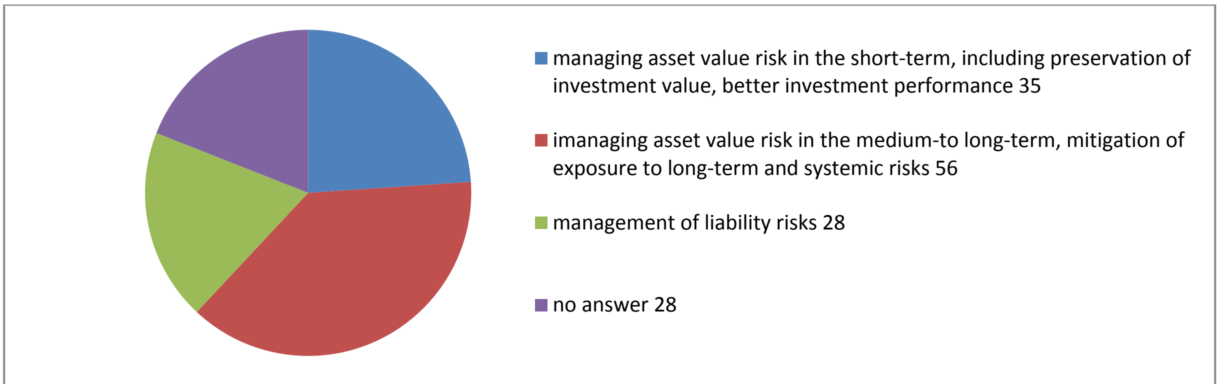
Ethical considerations and legal and regulatory constraints were also considered important although less often mentioned. Concerning the legal or regulatory constraints, the respondents referred in particular to the mandatory investment exclusions in force in several jurisdictions in the world (e.g. a cluster munitions ban in several European countries) and to national legislations providing for mandatory ESG disclosures by investors such as the French Law on Energy Transition. Other reasons to take ESG issues into account mentioned were long-term value creation, long-term economic sustainability and increased return. Chart 3 below presents how many respondents considered each issue important.

Chart 3: Rationale behind taking ESG into account:



As regards risk management, respondents who replied to this question considered managing medium to long-term risks and mitigation of exposure to systemic risks as the most important type of risk to be managed. The chart 4 below illustrates the number of respondents per risk type.

Chart 4: type of risk to be managed



Question 2a
Which ESG risks do you perceive as material to investors?

Overall respondents explained that there was a broad spectrum of ESG risks that could be material and that it was not possible to define an exhaustive list of material ESG risks. The materiality of an ESG risk would depend on the company, in particular the sector and geographies in which it operates. It was stated that any ESG factor that could disrupt a company's business model, hinder the implementation of the management's strategy, lead to major operational problems, cause significant additional costs, damage reputation of the business or put at risk the company's license to operate should be seen as a material risk by investors.

Several respondents mentioned that materiality for investors would depend on the investment strategy and whether an ESG factor was financially relevant. It was said that the likely impact of ESG issues depends primarily upon the timeframe that the investor was considering. According to some respondents, for most investors the timeframe was short-term and medium-term. It was said that because most attention was paid to how the company and its share price would perform over the next year or two years at most, the vast majority of environmental and social issues were not considered financially material in conventional investment analysis.

Some investors pointed out that currently investors perceived the materiality of ESG risks in a short-term and medium-term perspective and at a company level. It was considered that this vision of ESG risks was relevant but not sufficient, because ESG risks were first and foremost long-term systemic risks. In this context, reference was also made to Bank of England's governor Mark Carney's statements on the impacts of climate change for the financial system.

It was also argued that investors in different asset classes might have different perceptions about the materiality of ESG issues. Bond investors would likely be more focused on the ESG risks, in particular to governance, while equity investors may take a broader view of risks and opportunities in informing their valuations. Furthermore, it was argued that materiality was a dynamic concept which would evolve over time. This evolution is driven by legislation, changes in understanding of risks as well as social, environmental and economic impacts of the ESG in question and societal expectations. It was argued that financial materiality could be increased by the regulator, for example with a meaningful carbon price, proper access to redress for communities affected by negative corporate behaviour or proper sanctions[4].

References were made to research showing that there has been a significant shift by investors to considering ESG risks as being relevant to all sectors of industry, rather than being a concern only to specific sectors. One respondent argued that over 80% of a company's valuation today is found in non-financial information and ESG issues are increasingly becoming strategic concerns for companies. Some ESG risks were seen by some respondents as being material to all types of investments, for example governance, fraud, bribery, corruption, climate change, pollution, employee relations, human and labour rights, etc.

Examples of risks mentioned by respondents across all categories:

- Climate change and carbon emissions as well as other environmental issues such as resource use and efficiency (including energy), water, waste, air and water pollution, biodiversity, and deforestation were very often mentioned. For climate change, it was

[4] For example, it was explained that the 2015 UK modern Slavery Act increases the material financial risks for companies who use slave labour in their supply chains by creating 2 new civil offences linked to modern slavery.

argued that three types of risks are material: physical climate risks, transition risks and legal risks. Social and labour standards, risks associated with health and safety, supply chain labour standards and human rights were given as examples of social risks.

- Governance issues were generally seen as a fundamental underlying factor for most companies. Examples given were corporate culture, standards and values – including anti-bribery and corruption, board leadership, structure and accountability, board appraisals and risk controls – and reputational risk management.

Question 2b
What are the main sources of reliable and relevant information for investors on material medium- to long-term risks and opportunities, particularly on ESG issues?

All respondents across all categories[5] pointed to a wide variety of information sources, distinguishing mainly between information emanating from the investee companies and information provided by different external research or analysis. Although the data availability and quality had increased significantly in the last years, many respondents questioned the reliability, credibility and comparability of available information.

Respondents considered that <u>company disclosures,</u> such as financial statements, auditor's reports, management reports, corporate governance statements, etc. were the primary information sources. Several respondents considered the direct relationship (including direct engagement, dedicated questionnaires etc.) with companies as very important.

However, many respondents underlined that while most listed companies provided some form of ESG information, the quantity and the quality of information varied significantly. A number of respondents considered that the link between ESG information and financial information was not sufficient and that data provided by companies was not representative enough of the company's overall ESG risk profile. Several respondents complained about lack of clarity and consistency as regards the scope of reporting, key performance indicators, metrics and methodologies used. Some respondents considered that information focussed on risks and not sufficiently on opportunities and that the ESG information tended to be retrospective rather than forward looking.

For the vast majority of respondents lack of widely accepted standardised framework for ESG reporting was a key issue. Although some respondents welcomed standardisation initiatives such as the Global Reporting Initiative or integrated reporting, it was also considered that the existence of numerous competing non-binding standards could increase the complexity and cost of information to be analysed.

As to <u>external information</u>, respondents pointed to a wide range of sources, including mainstream financial data providers, analysis and credit rating agencies but also dedicated ESG databases, research, analysis, ratings, indices, benchmarks and labels. Respondents also referred to information emanating from civil society, academic and think tank research, as well as media and investors' collaboration groups.

However, some respondents claimed that the reliability of external sources varied. According to a few respondents, common, measurable and comparable data was not yet sufficiently available and many sustainability indexes measured only one or some particular ESG aspects making it more difficult to see the bigger picture. Few respondents explained that data

[5] As the question was formulated from the point of view of investors, regardless of the nature of the respondent, the answers reflected the perception of investors' views (e.g. NGOs referred to how they perceive investors' opinion)

providers' and analysts' methodologies were not always transparent. Numerous respondents also underlined that data offered by ESG data providers requires significant expertise to be translated into meaningful investment decisions. Some investors pointed out that no external data provider is today capable of providing all information needed for the investment process.

Some respondents underlined that the amount of data sources to be monitored exceeds the capacity of most investment teams.

Question 2c
Is it difficult for investors to access such information? If so, please specify.

The vast majority of respondents[6], in particular institutional investors, asset managers and their associations and NGOs, considered that it was difficult to obtain ESG information which would be appropriate for investment decisions. Although many respondents acknowledged clear improvement of ESG reporting over the last decade and welcomed ongoing developments at EU and international level[7], they considered that ESG information remained an issue. For most respondents, the main problem was not the access or availability of information, but rather lack of relevant, reliable and comparable information. As illustrated by an institutional investor: "*it would be hard for an investor to be expected to reduce its exposure to water risk when most large companies in most sectors do not report their water usage, or do so using different standards and methodologies."*

Few respondents underlined that 'comply or explain' may not be the right tool to incentivise companies to disclose ESG information and that compulsory reporting would be more effective.

Many respondents underlined the role of external providers in aggregating information or providing research and analysis, but considered that while access to some basic ESG scores and raw quantitative data was easy, it was still difficult and costly to access valuable research and analysis.

Question 2d
Is access to such data expensive? If so, please specify.

Respondents had diverging views on this question. Institutional investors, asset managers and their respective associations generally considered that access to ESG data had a cost and may be expensive. The cost depended on the scope type and coverage of the requested data and the assurance level. In addition, data could either be gathered internally, resulting in cost for staff or bought from specific external data providers. While company disclosures were available free of charge, the cost of third-party data depended on the number of holdings across portfolios and the number of data providers employed. Especially access to tailored research could be costly.

However, numerous investors were of the view that costs were relative to the size of the investors. While the costs were manageable for larger investors, they could sometimes be prohibitive for smaller investors. Independent research remains only available to those that can afford it and it is not accessible to smaller investors and civil society.

[6] As the question was formulated from the point of view of investors,, regardless of the nature of the respondent, the answers reflected investors' views (e.g. NGOs referred to investors' opinion).

[7] In particular Directive on Non-Financial and Diversity reporting or the work of the FSB task force on Climate-related Financial Disclosure

For several investors, the costs related to ESG data did not seem high in the overall scheme of the investment process. Many investors also underlined that the costs of high quality ESG analysis would be outweighed by the benefits of mitigating the risks and identifying opportunities thanks to obtaining the right information. They stressed that the investment would pay off in mid to long term. Some also considered that although the information provided by 3rd providers was not cheap, it was more efficient to purchase this information than to collect and analyse it by the investor itself. Some NGOs claimed that investors overestimated the costs because they were not convinced that there was significant value in considering ESG issues in the investment process.

In general, a number of respondents considered that more standardised reporting through sector-specific frameworks and the creation of 'one-stop shops' for ESG information could reduce costs.

Question 2e
What factors may prevent or discourage companies from disclosing such data?

The respondents across all categories listed similar issues which may prevent or discourage companies to disclose ESG data. The following were mentioned most often: possible reputational risks, potential liability issues, costs associated with the collection, analysis and disclosure of ESG data, lack of capacity to measure certain risks, existing confidentiality agreements, competition concerns and the absence of ESG in companies' strategic frameworks. It was also mentioned that collecting ESG information required robust internal systems and processes at investee companies, which many issuers (particularly small and mid-sized companies) did not have. Other reasons for why companies might not publish ESG data included lack of consistent and internationally accepted definitions regarding many ESG metrics and market practise and regulatory framework.

Mainly business federations, but also some investors, argue that certain ESG information may be material to the company's strategy or related trade secrets and therefore could not be disclosed to competitors. Furthermore, collecting information from subsidiaries and supply chains could be costly.

A few investors and a public authority mentioned that the company’s governance structure and shareholder structure could play a role. For example, where a company has a large controlling shareholder it may consider it unnecessary to improve transparency as the large shareholder in effect provides a shield from minority shareholders' views or votes. Some investors, business federations, NGOs and public authorities were of the view that many companies did not understand the added value of ESG information and how investors use it.

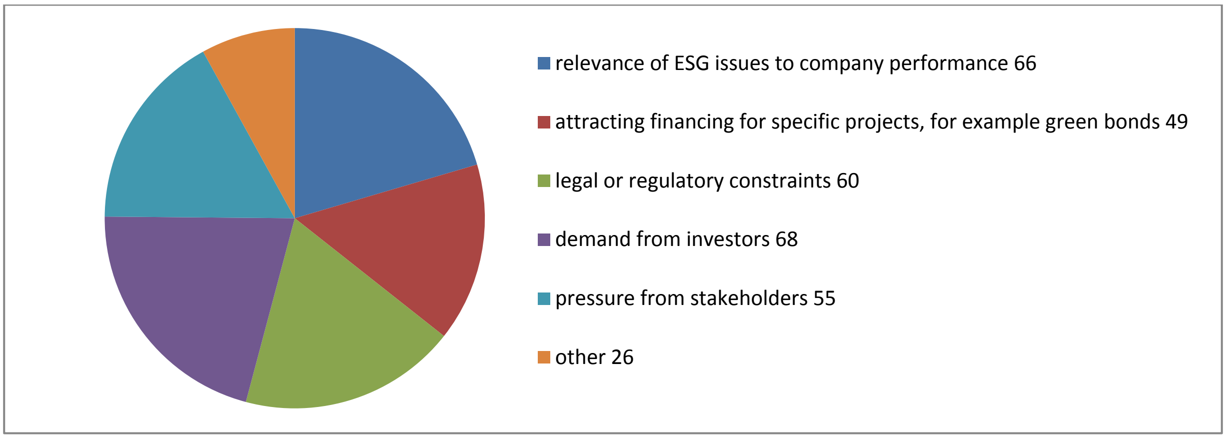
On one hand, it was also claimed that information that was inherently negatively oriented, such as environmental impacts or social risks generally discouraged companies from disclosing such data and the disclosure conduct by peers influenced companies' behaviour. On the other hand, a trade union was of the view that companies with poor environmental and/or social performance may have an interest in not publicizing such data, as the disclosure may be harmful to the image of the company.

Some investors, NGOs and a trade union association considered that because there was no mandatory framework for reporting, companies do not disclose the necessary information *("why disclose what we do not have to?").*

Question 2f
What is the main rationale for companies to publish such information? Please indicate all the relevant issues (relevance of ESG issues to company performance, attracting financing for specific projects, legal or regulatory constraints, demand from investors, pressure from stakeholders, other)

Generally, the large majority of respondents considered all the reasons included in the chart below as relevant. More specifically, it was indicated that these reasons were not mutually exclusive and that they differed from one company to another according to its level of maturity, to the legal constraints of its country of operation, to the nature of its activities, etc. The chart 5 below illustrates how many times each rationale was considered by respondents.

Chart 5: Main rationale for companies to publish ESG information



Other reasons to publish ESG information mentioned by the respondents were for example: reputation, branding, competitive edge, the objective to lower the cost of capital, peer pressure, the aim to get access to a leading sustainability index.

Question 2g
Is there sufficient accountability for the disclosure by companies of such information?

The large majority of respondents from investors, professional associations, NGOs, and a respondent from trade union side were of the view that although the accountability has been improving, it was not sufficient. Many respondents stated that the quality of ESG information was lagging behind the quality of financial information. Overall many respondents found that the lack of common standards and assurance hindered proper disclosure and accountability for ESG information. Lack of regulatory monitoring mechanism or proper sanctions for inadequate disclosure was also mentioned. One investor association argued that it is often difficult to form investor coalitions with sufficient weight to represent proper accountability. Many respondents also considered that the accountability varied according to some of the following factors: the type of company, the type of information disclosed, methodologies used to measure performance and whether performance was easily measurable.

Some investors and companies considered that board oversight or involvement of the audit committee was important and even sufficient, while others tended to prefer external assurance which would add credibility to investors and external stakeholders. It was suggested several times that the integration of financial and non-financial information in a combined corporate reporting would also increase the accountability of companies for the disclosure on ESG issues.

A number of contributors, particularly NGOs, were of the view that inconsistent data and limited investor use was creating a vicious circle where no party was taking the lead to create the required accountability.

A small minority of respondents, particularly business federations, considered that accountability was sufficient.

Question 2h
What are the best practices as regards internal corporate governance processes to ensure proper reliability of the disclosed information?

The majority of respondents across different categories (investors, business federations, companies, NGOs, etc.) highlighted the key role of board level oversight and responsibility for monitoring and disclosure of sustainability information. In particular, it was mentioned that to fully integrate sustainability practices and related reporting processes into a company's operations, a sustainability strategy supported by the board was essential. Many respondents pointed to the establishment of a sustainability or other independent committee at board level as best practice.

Many respondents, particularly investors also emphasised that the ESG data should be assured internally through internal audit or other control processes, and/or externally by an independent third party. A limited number of answers pointed to specialised sustainability departments or managers, and staff training programmes. In addition, investors and businesses stressed the importance of clear internal policies and implementation of responsibilities as well as coordination of sustainability related activities between management, the internal audit department, the external auditor and the sustainability committee. The importance of effective incentive alignment through inclusion of relevant ESG metrics in board remuneration was also mentioned.

Furthermore, some NGOs mentioned for example the importance of transparent stakeholder consultations on ESG issues, grievance mechanisms for individuals and communities that may be adversely affected by the operations of the company as well as independent verification of respect of human rights. A trade union organisation emphasised the role of trade unions and worker representatives in the monitoring and verification of companies' social performance as well as a truly independent auditing function.

Question 2i
What is the role of specific ESG investment instruments, like green bonds?

While most embraced the overall importance of such instruments, respondents had mixed views as regards their actual impact. An important number of respondents across all categories considered that ESG investment instruments, such as green bonds, climate bonds and social bonds could potentially play a positive role in driving investment towards more sustainable projects. Green or social bonds were seen as serving a wider economic, environmental and social need alongside generating financial return. They were also seen as potentially raising investor awareness about climate change and other environmental and social issues and attracting new categories of investors to sustainable investment products.

Green bonds were seen as an alternative capital market-based source of financing for green project. They enable companies whose business model is not oriented towards developing sustainable solutions to flag a responsible and long-term oriented product for investors.

On the other hand, a large number of respondents, particularly investors and their associations emphasised that the green bond market is still a niche and therefore it was difficult to judge whether these instruments offered real diversification possibilities and yield enhancement. Some respondents questioned whether existing green bonds had led to an actual increase in environmental investments.

Around one third of the respondents across all categories were of the view that although specific ESG instruments could play a useful role, the overall objective should be to mainstream ESG considerations in investment decisions across all asset classes. Specific ESG instruments alone would not achieve broader and deeper consideration of ESG factors in the investment process.

A number of respondents underlined the need for rigorous standards, reporting and monitoring. In this context, initiatives such as the Green Bond Principles and the Climate Bonds Initiative Standards were seen as positive development. However, some respondents, including investors and NGOs argued that although standards related to green bonds were evolving, there was no common understanding of what qualified as a green bond. Currently, there was no single reporting framework (e.g. on impact). Some NGOs and think tanks warned that investor confidence could be undermined unless definitions, standards and monitoring were brought in.

Question 3a
What should an appropriate long-term risk assessment methodology look like? Please indicate some examples of good practice.

The majority of respondents across all categories considered that a proper long-term risk assessment methodology must include an analysis of ESG issues. Many argued that it should not be limited to backward looking analysis of purely financial data. However, a number of respondents underlined that there is no 'one size fits all' risk assessment methodology.

Many respondents emphasised the need to focus on material ESG factors that are likely to have a significant impact on the (longer-term) sustainability of a company's business model and its share price. The need for a macro view, planning of different risk scenarios and stress testing for the impact of certain risks was emphasised. Some investors also pointed to the need to consider risks both at portfolio level (systematic monitoring of portfolio exposures to themes such as carbon/climate risk, water stress or regulatory/legal/stakeholder problems) as well as at company/asset level (identification and monitoring of systemic, sector-specific and company/asset specific risks). Some respondents also underlined that engagement with the investee company allows a better understanding of risks.

A number of NGOs and academics were of the view that long-term factors, in particular ESG, were not sufficiently integrated in the risk assessment methodologies in the financial sector and that there was no overall good practice in this area.

Question 3b
Are there specific barriers, other than those of a regulatory nature (see question 9) for investors to integrate medium-to long-term risk indicators, including ESG matters in their risk assessment? If so, please indicate what you consider to be the main barriers.

The replies showed that the short-termism of the markets was the underlying problem. In addition, insufficient availability of comparable ESG data was raised by many respondents, especially investors as a significant barrier for more long-term investment approach (in this respect see responses to questions 2b and 2c).

A number of factors were seen to contribute to the short-termism:

- The importance of short-term incentives in the investment chain was highlighted. Despite the long-term liabilities of many institutional investors, they evaluate the performance of their asset managers based on quarterly performance against a capital market index or other benchmark. Fund managers also often have incentives linked to one- or three-year rolling performance. In some respondents' view, this resulted in herding behaviour and was considered to be a serious systemic issue. It was claimed that when decisions were taken in a short-term time-frame, certain ESG issues were not always considered to be material, therefore the market did not attribute a financial value to them. As low probability and catastrophic events were difficult to model, many investors preferred to 'gamble' that these risks would not materialize during their period of ownership of assets.
- Some respondents mentioned market structure issues that contributed to short-termism such as highly diversified portfolios, increased intermediation in the investment process and reduced bargaining power of institutional investors with asset managers.
- Some were of the view that ESG was difficult to reconcile with traditional finance theory and thus to integrate ESG into mainstream models of risk assessment. It was said that *'if carbon asset risk cannot be priced, how can it readily be incorporated into a financial risk model?'* A number of respondents, particularly investors mentioned that market players needed to develop processes that tie together financial value with non-financial measures. A number of investors pointed to further difficulties in integrating ESG into mainstream models of risk assessment/analysis which were typically based on the historic performance of assets with a track record of 5-10 years. Many sustainable investments did not have such track record and were therefore difficult to assess on that basis. It was argued that risk assessment was today largely disconnected from the real economy and focussed only on a comparative analysis of financial risks.
- Some respondents also pointed to the growth of passive investment strategies, where there was no risk assessment preceding investment decisions. It was argued that the scope for ESG integration in such strategies was significantly reduced as any consideration of ESG could only take place though engagement.

Finally, a number of respondents saw short-term focus of financial markets as a deeply rooted behavioural barrier. Despite research showing that ESG integration improved long-term performance, many pointed to a false belief that ESG integration limited investment horizons and lowered returns. A number of respondents underlined that most actors were not educated/trained to analyse ESG issues and therefore did not understand their importance. Some respondents claimed that the inertia within the investor industry made it very hard to change and thus adapt to new ideas.

Question 4a
When selecting and remunerating asset managers, how do institutional investors take into account asset managers' integration of ESG issues into investment strategies? What are the best practices in this area?

As regards selection of asset managers, most respondents, particularly from the investor side, acknowledged that institutional investors increasingly looked at ESG issues when awarding investment mandates. However, many respondents, including investors, considered that the approaches of institutional investors varied strongly. It was argued that for many asset owners such interests often meant formal commitment to high level principles which were not properly implemented in asset management mandates. To support these views, reference was made to research showing that the majority of institutional investors committed to the Principles of Responsible Investment had yet to ensure that these were effectively implemented in asset management mandates.

Respondents pointed to a variety of best practices for the selection of asset managers. Many mentioned inclusion of specific ESG questions in requests for proposals during the tendering process for new managers. Some respondents underlined the importance of in-depth screening of ESG credentials of asset managers and direct discussion on their awareness and strategy to manage ESG risks. It was also reported that some investment consultants provided evaluation of asset manager's approach to ESG, using the MSCI ESG Fund Metrics for measuring fund exposure to ESG factors.

As regards asset manager remuneration practices, the general view from all sides was that ESG considerations were currently not integrated at all or only to a minimum. Respondents did not appear to cite any concrete arrangement that would be applied in practice except in impact investing mandates. It was mentioned that in theory setting ESG goals/targets or inclusion of certain ESG factors in the valuation models used to assess the performance of the asset manager could be considered a good practice. As underlined by some respondents, a longer-term time frame for asset managers' evaluation and remuneration allowed them to focus not only on short-term performance but more on long-term impacts. Some respondents pointed to specific best practices in the context of impact investing funds, i.e. where the remuneration of the asset manager was aligned with social and environmental performance of the fund.

A few investor respondents argued that there was a lack of clear metrics that institutional investors could use to select and remunerate asset managers on the basis of their long-term ability to generate return and their performance as stewards of capital. It was argued that an appropriate performance benchmark or toolkit should be developed for long-term investing, remuneration and engagement activities.

Question 4b
Is ESG performance and active asset ownership taken into account in the remuneration of the executives and/or board members of institutional investors? What are the best practices in this area?

The vast majority of respondents across all categories that replied to this question reported that ESG performance was not at all or only to a very limited extent taken into account in the remuneration of the executives or board members of institutional investors. In the view of some investor associations, this was linked to the fact that it was difficult to measure specific ESG performance of an executive.

Regarding theoretical best practices, inclusion of ESG targets into the Key Performance Indicators for executives, allocating ESG aspects a 20% weight score in the variable remuneration award of specific ESG related bonuses or the use of claw-back clauses were mentioned.

Some respondents explained that although ESG was not taken into account in specific board remuneration, certain investors considered ESG performance in the general remuneration policies for all the relevant staff. It was argued that this practice is in an early stage, as demonstrated by a survey of pension funds in the Netherlands. The survey showed that only less than half of the pension funds set sustainability targets in the remuneration for employees.

Question 5a
Do you think that the lack of scale or the lack of skills and resources of some institutional investors may affect their ability to integrate ESG factors in investment decision-making and engage on such issues? If so, how? Please provide evidence if possible.

Views on this question were diverging. On the one hand, a small majority of respondents, in particular many institutional investors and their associations, a number of asset managers and their associations, some NGOs and a respondent from trade union side were of the view that scale and skills played a role. The following main arguments were mentioned:

- due to the complexity of certain ESG issues, such as climate change matters, investors needed considerable resources and internal capacities to properly integrate ESG;
- scale appeared to contribute to insufficient consideration of long-term factors when it came to allocation of asset management mandates and to directing and monitoring asset managers and
- resources mattered for shareholder engagement activities.

On the other hand, a very significant number of respondents including many institutional investors and their associations, many asset managers, NGOs and academics argued that the problem was more lack of conviction or determination, while scale and capacity were secondary. In their view, any investor should be able to understand how ESG factors affect the risk/return profile of companies and integrate ESG issues into investment decisions. It was argued that external analysis could be used for complex issues and smaller investors could engage on a limited number of ESG topics with a smaller number of companies only. Certain respondents referred to examples showing that many small investors were more active on ESG issues than larger funds and smaller investors were performing well on ESG. It was pointed out that smaller, specialized managers focusing on ESG as a source of competitive advantage are more likely to invest the necessary resources while larger institutions face more inertia for integrating ESG into their mainstream investment strategies.

Question 5b
Please indicate measures/practices that have contributed to enhance institutional investors' capacity and ability to integrate ESG factors in investment decision-making and engage on such issues.

Most respondents pointed to different voluntary initiatives. The Principles of Responsible Investment were mentioned most frequently. A number of other international frameworks and guidelines were also referred to, including the Global Reporting Initiative, Carbon Disclosure Project, International Integrated Reporting Council's integrated reporting framework, standards issued by the Sustainability Accounting Standards Board, the principles of the International Corporate Governance Network, the UN Guiding Principles and UNEP FI's work. Global investor commitment initiatives, such as the International Investors Group on Climate Change and the Portfolio Decarbonisation Coalition were also mentioned. Many investors also emphasised the useful role of labels and sustainable investment fora as well as other means for investor cooperation and best practice sharing.

Numerous respondents from all sides also pointed to different measures of regulatory or semi-regulatory nature. Concerning EU legislation, for example the directive on non-financial information was mentioned. As to national legislation, some respondents referred to the French energy transition law requiring investors to disclose their strategy on climate change, their exposures to climate change risks as well as portfolio carbon footprint and the French rule requiring companies which offer employee savings schemes to include at least one or two funds dedicated to responsible investment. The UK Stewardship Code and other national standards for investors were also mentioned by many.

Question 6a
To what extent can good internal governance of institutional investors, such as mechanisms aiming to align interests between beneficiaries, board and key executives, influence their ability and willingness to integrate ESG factors in investment decision-making and engage on these issues? Please provide evidence or good practices if possible.

The large majority of respondents that replied to this question, mainly investors, NGOs and a respondent from the trade union side, were of the view that proper internal governance arrangements and alignment with beneficiaries' interests played a very important role. Some respondents thought that governance arrangements could help advance ESG integration only if the investors and beneficiaries understood the importance of ESG issues.

A considerable number of respondents from investors, some NGOs, trade union mentioned that questioning beneficiaries for their views on ESG integration and/or allowing beneficiary representation in the investors' board was essential. Certain institutional investors provided examples how they had changed their responsible investment policies or decisions according to the wishes of their members.

Many respondents considered reporting on ESG risks, policies and performance as a key issue. Other governance practices were also highlighted. These included for example adoption of ESG targets and independent review of ESG performance, board responsibility for ESG matters, proper oversight mechanisms and incentives, a board member responsible for ESG issues and appointment of an independent responsible investment advisor.

Research was quoted to demonstrate that the best performing pension schemes globally - measured on a range of issues including responsible investment- tended to have an alignment of interests between key parties, including boards, executives, asset managers and employers. It was pointed out that non-profit pension funds where trustees were appointed by employers, beneficiaries or their unions outperformed for-profit pension schemes in Australia.

Question 6b
Do beneficiaries of pension funds and other institutional investors with long-term liabilities obtain sufficient and clear information about how the fund or investor is managing ESG risks? Can they give their opinion/be consulted on these aspects? Please provide examples of good practice.

The majority of respondents did not express a clear view on this question. Most respondents, mainly NGOs and a number of investors that gave an opinion considered that beneficiaries did not get sufficient information. At the same time, a number of respondents, in particular investors said that some ESG information was increasingly being provided to beneficiaries. While some respondents mentioned existing ESG reporting requirements in the biggest markets in Europe (the Netherlands, the UK, Germany, France), some of them considered that these requirements did not result in meaningful information for beneficiaries and included little detail about real ESG impact.

Responses appeared also to suggest that beneficiaries were rarely consulted on ESG issues. Some insurance associations reported that policyholders were often given a choice to select products that incorporate sustainability aspects. A number of respondents pointed to examples of good investor governance practices. These included the presence of saver representatives in the pension funds' board or the right for a stakeholders' body to approve the strategic investment policy in the Netherlands. Other specific bodies were also quoted, such as an independent governance committee acting on behalf of beneficiaries.

A few respondents argued that future policies should aim at improving disclosure requirements, addressing the lack of diversity in governing boards for pension schemes, requiring more systematic involvement of savers (e.g. through AGMs, surveys, right to receive a substantial reply) and promoting online tools to interact with beneficiaries when developing investment policies.

Question 6c
Are beneficiaries interested in matters referred to above? Please provide evidence if possible.

A clear majority of respondents, in particular institutional investors, asset managers, service providers, NGOs found that beneficiaries' interest in ESG matters was increasing. Some of these respondents also claimed that interest would further increase with better reporting. An important number of respondents said that beneficiaries were generally interested in ESG or socially responsible investment. Several respondents claimed that pension fund beneficiaries had been the driving force behind recent growth of sustainable investment practices in Europe. Some respondents also considered that most beneficiaries clearly wished to receive more general ESG information, but were not necessarily interested in detailed ESG information because of its complexity.

Several responses appeared to suggest that beneficiaries' interest was more apparent in the Nordic countries, the Benelux and the Anglo-Saxon countries than in the rest of Europe. Some provided evidence about significant beneficiary interests in these countries. For example surveys among UK pension fund beneficiaries had showed that nearly two thirds of beneficiaries were interested in receiving information about how their savings were invested, and that a high number of pension fund beneficiaries contacted their funds in respect to ESG matters. Examples were also provided about successful campaigns in Nordic countries which resulted in mobilising enough savers to put a resolution on fossil fuel divestment on the agendas of the annual meetings of several pension funds. Some respondents also pointed to the presence of active, dedicated associations in the UK and Nordic countries. A global survey was also quoted showing that 60% of institutional investors in the world received questions on the composition of their portfolio. 40% of the questions were related to ESG.

A minority of respondents including institutional investor associations were of the view that beneficiaries did not generally show great interest in ESG matters. Some respondents claimed that while beneficiary associations could be very active, there appeared to be a silent majority of pension fund members who were not engaged. A number of respondents were of the view that lack of interest was generally due to the low level of understanding of how pension investment worked.

Question 7a
Is there sufficient long-term oriented, reliable and relevant external investment research? Are there barriers to good quality external investment research on ESG risks and opportunities? If so, please explain. What role, if any, do financial incentives or conflicts of interests of some service providers play?

Despite a recent increase in sustainability research and ratings, many respondents considered that the market remained limited. Most responses including from investors, NGOs, and a respondent from the trade union side appeared to suggest that there were important barriers to the development of this market. This resulted in insufficient quality or methodologically biased research which the investors had difficulties to properly integrate into investment decisions.

The following main barriers were mentioned by a large number of contributors:

- lack of demand from the investors: particularly NGOs, investors and service providers found that lack of demand is a problem. According to some respondents, there may be a "chicken and egg" issue here. Investors were seeking short-term solutions and were unwilling to invest in time- and cost-intensive development of a new generation of risk models. At the same time, service providers were unwilling to provide such services until investor demand was clear, but investor demand was also dependent on supply;
- backward looking research: some contributors including investors and service providers were of the view that most ESG research focussed on processes and consisted of short-term and backward looking indicators. Making up models for future expected risks was seen as a real challenge in this area;
- conflicts of interest: many respondents, in particular investors, pointed to a number of examples of conflicts of interests such as research agencies offering both rating and company advisory services and brokers working for investment banks which offer both sell-side research to investors and advisory services to companies. It was claimed that a clear signal of such conflicts of interest was that the vast majority of large banks did not provide corporate governance analysis in their research;
- lack of proper definitions and sector-wide quality standards: a number of investors, public authorities and NGOs claimed that apart from a limited number of initiatives, no sector-

wide quality standard exists. They considered that agencies were developing their own assessment methodologies, which were often proprietary and lacked transparency. It was, however, underlined that the quality of investment research depended on the quality of information which was available for the service provider.

Question 7b
To what extent do investment banks, investments analysts and brokers provide information on medium-to long-term company performance, including corporate governance and corporate sustainability factors, when they make buy, sell and hold recommendations to investors?

The majority of respondents, in particular investors, service providers, public authorities, trade union argued that brokers, analysts and investment banks rarely integrated ESG into mainstream investment research. This was seen as an important shortcoming because the majority of investors used sell-side analysis as a key input into their investment decisions. Many acknowledged that the situation was improving.

Several investor respondents mentioned that some investment banks/brokers had dedicated ESG teams. However, ESG analysis was most often presented as a separate thematic report and not incorporated into company-specific buy, sell and hold recommendations. A number of respondents argued that this lack of integration was largely due to the short-term nature of sell-side broker research which aimed principally to promote short-term trading (brokers' remuneration being directly tied to trading volumes). It was also mentioned by a number of respondents that brokers may seek to avoid reporting negative information for fear of losing access to boards of investee companies and damaging the commercial relationships of the mother bank with the investee company.

Some asset managers and their associations showed a more positive picture. They argued that most brokers had added ESG expertise to their services and competition had increased significantly in the last 2-3 years. However, it was seen important for these teams to continue getting the financial support for proper resourcing. A number of respondents argued that the qualification of research as inducement under MiFID II was a barrier and that explicit exclusion of ESG related research from the scope of inducements could foster ESG research.

Question 7c
To what extent do investment consultants consider the asset managers' approach to ESG issues and active asset ownership when advising institutional investors about the selection of asset managers?

The large majority of respondents considered that investment consultants did not sufficiently consider ESG performance and active ownership. Many appeared to consider that the practice had, however, been improving in the last years.

Several respondents, in particular from the institutional investor side, emphasised the critical role of investment consultants in the investment chain. They argued that many institutional investors were small and did not have the resources to manage assets in house and therefore relied heavily on the advice of investment consultants in the selection of asset managers.

A number of respondents including institutional investors and NGOs said that although some consultants had good ESG teams, the mainstream consultants rarely covered ESG issues in the discussions with most pension funds. Even leading consultants only considered ESG approaches upon specific request from their clients or only in cases where the institutional investor had a legal obligation to take ESG issues into account. In these respondents' views, lack of appropriate advice from consultants lead to suboptimal asset management mandates.

Research was brought forward which also showed that investment consultants rarely raised ESG issues with pension funds and typically took a narrow view of the fiduciary duty that was focused on immediate financial return. Several respondents mentioned that because investment consultants’ incentives were currently not aligned with the long-term performance of the pension funds, they encouraged frequent changes of asset managers. Incentives were such that consultants received higher fees for the selection of a new manager than for being retained as an advisor.

At the other side of the spectrum, mainly some asset managers and their organisations considered that consultants took ESG performance systematically into account, even if it was only a small part of the assessment. In case they did not, this was because of an insufficient demand from the investors.

Question 7d
To what extent do proxy advisors consider medium-to long term performance of companies, including ESG performance, in their voting recommendations?

Most respondents did not have a clear view on this issue. Around half of those who replied considered that proxy agencies played a useful or increasing role while the other half of the respondents was more critical and claimed that they did not sufficiently consider ESG issues.

A number of respondents were of the view that proxy advisors promoted good governance and increasingly considered long-term factors in their recommendations. At the same time, many respondents, including certain investor organisations, indicated that most proxy advisors focussed only on governance and that only niche players might take a strong position on environmental and social issues.

Some respondents pointed to the limitations of what proxy advisors could do. They could advise investors on how to vote in the general meetings mainly concerning governance issues. Contrary to the US, environmental and social issues rarely feature on the agenda of general meetings in Europe. However, it was noted that even though proxy advisors' default voting policies did not incorporate ESG criteria, they may be able to tailor their advice for clients with a stronger focus on ESG.

It was also argued that proxy firms were starting to look at how executive pay was linked to metrics aligned to ESG factors as drivers of long-term value creation. However, respondents were not able to provide examples of advisors having recommended voting against an executive remuneration policy because it did not include ESG criteria. Some respondents were of the view that proxy voting agencies providing general meeting voting advice to their clients focussed typically on the current state of play and their positions were not tilted towards a longer, more holistic viewpoint.

Question 7e
To what extent do credit rating agencies take medium-to long term performance of companies, including ESG performance, into account in their ratings?

The large majority of respondents across all categories were of the view that traditional credit rating agencies (CRAs) did not sufficiently take ESG issues into account in their ratings. A number of respondents pointed out that the main CRAs were beginning to address ESG issues but this was still very limited. Some respondents stated that governance issues were better integrated than environmental and social issues.

A number of respondents pointed to the importance of specialised rating agencies which provided specific ESG ratings. However, many respondents argued that there was a need for traditional CRAs to better mainstream ESG integration in their methodologies and be more transparent about how they do it.

Some respondents pointed to methodological issues. The horizon of the CRA (maximum up to 5 years) was shorter than the maturity length for debt securities (often 30 years), which strongly discouraged the integration of medium to long-term risks. It did neither correspond to the long-term horizon of most institutional investors. Some respondents argued that as the CRAs gave a view about the solvency of an issuer, they considered ESG criteria as soft factors and the impact of ESG on the rating as being very limited or non-existing.

Some respondents also claimed that CRAs mainly looked at historical performance of companies and were not able to respond to threats until they materialised. Critical respondents pointed to overnight re-evaluations as a reaction to scandals or other events demonstrating the weaknesses of CRAs methodologies. Certain respondents suggested that CRAs should be required to consider long-term ESG issues on a "comply or explain" basis over the full duration of the assets and to integrate ESG into risk assessment in their analysis.

Question 7f
What are the best practices as regards independent external assurance (for example auditor review) for the disclosure by companies of material medium- to long-term risks and opportunities, particularly ESG issues?

Most respondents that expressed a view on this question, in particular investors and NGOs, suggested that some form of assurance was needed to increase the robustness and trustworthiness of the disclosed information, but views were diverging about the best practice.

Some respondents, in particular investors, NGOs, and a respondent from trade union side claimed that the ESG external assurance market was still in its infancy and that audit companies were so far only providing a limited amount of service in this area. Therefore, best practice was yet to emerge. Some responses suggested that external assurance today predominantly focussed on internal processes (mainly the robustness of internal control systems) and only very rarely on the relevance of selected performance indicators. Some asset managers and their associations considered the assurance of process to be the minimum necessary. Certain other respondents, including institutional investors and some other service providers argued that a materiality check was also necessary and that robust external verification using common performance measures to ensure comparability was important. In addition, it was suggested that the external auditor should also evaluate the long-term systemic impact of the company's product and business model as well as the company specific risks and opportunities.

Respondents also pointed to some existing standards for assuring sustainability disclosures[8]. Some respondents underlined the advantages of integrated reporting in this context. Some pointed to the French legislation which required companies to include ESG information in their annual report and submit it to verification by an independent third party. The involvement of trade unions and employee representatives in the monitoring and verification of social performance was also suggested as possible best practice by trade unions.

Question 8a
Do you know of initiatives that led to more sustainable and responsible investment from non-professional investors? Please provide details about them.

A number of respondents, in particular institutional investors and asset managers, acknowledged the growing interest of retail investors in responsible and sustainable investments. However, some considered that it remained difficult for retail investors to identify high-quality ESG investment products. A number of contributors emphasised the importance of giving proper information to retail investors. In this context respondents mentioned numerous initiatives aimed at supporting the development of responsible investment of retail investors.

Responsible investment (SRI) labels were mentioned most often[9]. The creation of an EU label was proposed. Some respondents considered however that it may still be premature to draw conclusions about the success of the SRI labels. Few investors also mentioned the role of ESG ratings, such as Morningstar Sustainability Rating for Funds. A number of respondents highlighted the useful role that sustainable investment associations and other NGO's play in raising awareness and educating retail investors.

A number of respondents pointed to the growing importance of non-professional or semi-professional investors in the context of impact investing and social finance. Certain respondents reported that semi-professional investors, such as family offices, charitable foundations and high net worth individuals were among leading investors in impact investments and that the impact investing market was now also supported by an increasing number of retail investors. It was pointed out that the growth of the impact market could be seen as a failure of the institutional sector to deliver meaningful sustainable and responsible investment opportunities.

Social finance initiatives were also mentioned by some respondents who underlined that the European Social Entrepreneurship Funds (EuSEF) regulation also targets non-professional investors.

[8] In particular AccountAbility AA1000 Assurance Standard or IFAC International Standard on Assurance Engagements (ISAE 3000)

[9] In particular the German Sustainable Investment Forum's (FNG) SRI label, the Novethics SRI label and the CIES label (ie. socially responsible funds certified by a coalition of trade unions for employee savings schemes) in France, the LuxFLAG label in Luxembourg and two recent public labels introduced by regulation in France, ie. the Socially Responsible Investment (SRI) label and the Energy and Environmental Transition for Climate (TEEC) label

Question 9a
Are there legal or regulatory constraints likely to significantly and unduly prevent or discourage investors from taking a long-term view in their investment strategies and decisions and from investing in a sustainable way? If so, please provide details.

The majority of respondents, in particular institutional investors and their associations, NGOs and a large proportion of asset managers and their associations, considered that certain legal or regulatory constraints constitute a barrier to long-term investments. In this regard, solvency and liquidity requirements were brought forward most often.

Many respondents, particularly investors, including their main associations, and NGOs, argued that certain prudential (in particular Solvency II and CRDIV/CRR) and accounting regulations (in particular IFRS 9) discourage a long-term approach. Respondents pointed out that prudential frameworks are based on a risk assessment over one year horizon and that provisions requiring a level of capital proportional to the level of risk only take into consideration financial risks. Some respondents suggested that regulation should better define risks by taking into account systemic and other long-term risks that mostly depend on extra-financial issues. Furthermore, capital frameworks relying on traditional, backward looking risk assessment models calibrated on historical data were not considered as appropriate.

Certain respondents also claimed that liquidity requirements constitute a disincentive to invest into illiquid assets and that liquid assets are often treated more favourably when they are invested than illiquid assets. Some respondents also reported that as consequence of central clearing requirements regarding derivative transactions (EMIR, CRD IV) central counterparties require cash as variation margin, which additionally increases the need for liquidity. It was also argued that Solvency II creates a disincentive for insurance companies to invest into equity as debt related instruments are subject to a lower capital charges that equity instruments. Certain investors also indicated that asset diversification requirements may prevent them from concentrating their portfolios which would make it easier for them to monitor investee companies and to have a long-term approach.

Several respondents, including certain investors and the main investor associations and service providers, claimed that minimum solvency requirements and accounting rules have pro-cyclical effects. According to them, accounting rules require investors to value their assets at market value (mark-to-market) and to import market volatility into their balance sheets. This may force them to sell assets at times of falling prices without any consideration to the fundamental value of these assets or to their ESG characteristics. In the respondents' view, the prospect of potential forced sales may discourage long-term investments ex-ante.

Some respondents explicitly asked for an appropriate revision of relevant EU financial regulation to facilitate a long-term horizon in investment decisions.

Certain insurance companies complained that institutional investors are prevented from investing in energy projects along the whole value chain due to the restrictive application of the current unbundling regime in the Gas and Electricity Directives[10]. Since investments by institutional investors cannot be seen as strategic but only as financial investments there is consequently no risk of negative implications for the competition in the energy sector from these investments. In these respondents' views, the directive should be amended.

Furthermore, many respondents pointed also to the lack of clarity around the fiduciary duty (see responses to question 9b).

[10] Directives 2009/72/EC and 2009/73/EC

A minority of respondents, including certain investors and asset managers did not consider legal or regulatory constraints as a significant obstacle to long-term sustainable investment.

Question 9b
Do you believe that there are any barriers to the understanding by institutional investors and asset managers of their fiduciary duties that would not enable them to appropriately take ESG factors into account in their investment decisions? Please explain.

The majority of those who replied to this question, particularly institutional investors, their associations, service providers and NGOs, were of the view that there were barriers to the understanding of fiduciary duty which affected the willingness of investors to integrate ESG issues in investment decisions.

In these respondents' view, despite reports and studies clarifying that ESG issues were compatible with fiduciary duty and that the fiduciary duty imposed the obligation to take financially material ESG issues into account in investment decisions, outdated concepts of fiduciary duty, interpreted as obliging investors to maximise short-term value, still exist. A number of respondents pointed out that fiduciary duty could in practice be used as an excuse for not integrating ESG factors into investment decisions or into investment advice. Some also pointed to an erroneous and narrow understanding of ESG issues according to which ESG covered purely ethical matters without any consideration of financial impact.

Some institutional investors and their associations pointed to certain factors that contributed to the narrow vision of fiduciary duty, such as difficulties in integrating ESG issues into existing valuation models. These models mainly used backward looking data and were not appropriate to measure future risks. Prudential frameworks which did not recognize that considering ESG may reduce risk were also seen as contributing to a narrow interpretation of fiduciary duty.

Many respondents called for action to clarify fiduciary concepts in financial regulation in order to explicitly specify that such duty allows or even requires taking ESG issues into account. Some respondents emphasised the need to clarify duties for all actors along the investment chain in order to ensure that all of them act in the best long-term interest of beneficiaries. They pointed to the fact that asset manager obligations were often contractual and thus the duty was less clear. Such clarification would make it easier for asset managers to operate cross-border. This could be done through guidance or recommendation according to some respondents, or through revision of financial legislation according to some others.

Some respondents also suggested more education and training for employees of institutional investors, asset managers and other services providers in the investment chain, in particular investment consultants.

A minority of respondents, in particular some asset managers and their associations, did not view fiduciary duties as a barrier.

Question 10a
Are you aware of any other incentives or obstacle(s) with a significant impact? If so, which ones?

Nearly half of respondents pointed to further obstacles or incentives to the development of sustainable investment.

The following issues were mentioned as further barriers:

- investor misperceptions about ESG investment resulting in lower performance;
- lack of clarity around main ESG concepts and definitions giving rise to diverging interpretations;
- insufficient knowledge about ESG in the investment universe and low financial literacy of end investors;
- financial resources needed for staffing multidisciplinary teams and for technological solutions, such as software development;
- continued unconventional monetary policy contributing to low interest rates and eroding the financial buffers of institutional investors poses risks to ESG investing and to financing the transition to a climate neutral economy;
- capital gains taxes on equity/bond and fund investment which may divert savings into products that are blind to ESG factors.

The following incentives were mentioned:

- proper long-term perspective and long-term incentives in financial regulation (e.g. the French energy transition law, Article 173 on investor transparency);
- tax issues, such as carbon tax. It was reported that in the absence of a proper price on carbon, green companies may underperform their peers financially and face funding difficulties. Negative externalities must be priced at a level that reflects their true long-term cost to society. Taxing negative externalities was seen as more robust than subsidies as it reduces regulatory risk (i.e. the risk that subsidies become too successful and need to be withdrawn early). In addition, tax reduction for social finance was mentioned;
- role of EU stock exchanges in improving sustainability through development of a comparable and robust approach to listed companies' disclosure on sustainability including in the context of the Sustainable Stock Exchange Initiative;
- technological development, in particular harnessing the benefits of "big data" in order to better tailor ESG ratings to reflect investors' concerns.

Question 10b
Would you consider further increase in sustainable investments if market or regulatory conditions for sustainable investment would be more favourable? If so, please provide estimations, if possible.

The large majority of respondents that replied to this question would consider further increase in sustainable investments if market or regulatory conditions would be more favourable. A number of respondents were of the view that ESG investment would increase anyway, without regulatory intervention.

Many respondents mentioned that regulation would drive sustainable investments most. Financial and fiscal incentives have been commonly mentioned, in particular a strong carbon price and the avoidance of retroactive changes to tariffs and subsidies. Some insurance companies and organisations pointed to lower capital requirements and appropriate regulatory treatment of investment in renewable energies.

Some asset managers and their organisations cautioned against making ESG investment a compliance issue. A number of others saw a role for the regulator in this area (e.g. to increase transparency for company disclosures on extra-financial impacts, guidance on how to integrate ESG into investment strategies).

Certain contributors, including asset managers and academics, asked the EU to undertake a systematic review of how existing and prospective regulatory initiatives support the objective of promoting long-term, sustainable investment and prepare an action plan to re-align the incentives within the investment chain.