

Executive Summary

In the aftermath of the financial and sovereign debt crises, sustainable finance could provide the best opportunity for the European Union to reorient its financial system from short-term stabilisation to long-term impact. The EU has been leading on the global sustainability agenda, which seeks to combine economic prosperity with environmental and social sustainability. The EU also recognises that the goal of sustainability must be supported by a financial system that promotes growth in a way that is sustainable over the longer term.

The EU must now develop a clear strategy that unifies this ambition with one of its key achievements in terms of financial policy and regulation, and which also funds the path towards a low-carbon, resource-efficient and environmentally protective economy. To that end, in December 2016, the European Commission established a High-Level Expert Group (HLEG) on sustainable finance. The HLEG's objective is to help to develop an overarching and comprehensive EU strategy on sustainable finance to integrate sustainability into EU financial policy. It brings together experts with diverse profiles representing different approaches to this complex topic.

While EU reforms following the financial crisis managed to stabilise the financial system, the challenge is now to improve its contribution to sustainable development. The functioning of the financial system thus needs to be refreshed in the dual context of stimulating job creation, investment and prosperity in Europe, as well as making the transition to a sustainable model of development. Responding to the challenge of long-term sustainable development is also a powerful way for financial institutions to reclaim the positive role they can play in society.

This Interim Report of the HLEG identifies two imperatives for Europe's financial system. The first is to strengthen financial stability and asset pricing, by improving the assessment and management of long-term material risks and intangible factors of value creation, including those related to environmental, social and governance (ESG) issues. The second is to improve the contribution of the financial sector to sustainable and inclusive growth, notably by financing long-term needs such as innovation and infrastructure, and accelerating the shift to a low carbon and resource-efficient economy.

1. PROCESSES AND PARTICIPANTS IN THE FINANCIAL SYSTEM

Fiduciary duty and related concepts: The responsibility of directors and investors to manage long-term sustainability risks should be enshrined in their relevant duties, whether it is through fiduciary duty in common law or its equivalent in other legal systems. Updates should make clear that managing ESG risks is integral to fulfilling these duties. Policy and regulatory interventions will also have to promote the advancement of market-based tools essential to investment decision-making, such as benchmarks and credit ratings.

Disclosures: Clear, comprehensive and comparable disclosure of information on sustainability are essential to success. Better financial and ESG reporting by firms and financial institutions is urgently needed to reflect a truer picture. Developing broadly accepted standards for measuring performance, impacts on carbon, health and safety, and human capital would support better-informed decision-making. Investors should provide forward-looking analysis of how their portfolios are aligned with the energy and environmental transition, potentially via mechanisms comparable to France's recent Energy Transition Law, Article 173.

Putting sustainability at the heart of the financial system: To deliver systemic change, ESG factors and long-term sustainability risks and opportunities will be needed in corporate governance, core indices, accounting standards and credit ratings. They will also need to be reflected in the role played

by the European supervisory agencies (ESAs), such as through common guidelines and, subsequently, supervisory convergence on ESG disclosure.

The role of banks: As the largest asset pool, banks have an essential role in the transition towards a sustainable financial system. To date, however, their potential contribution to sustainable development has not reached its full potential. Green-supportive factors or brown-penalising factors could be investigated; the appropriateness of the capital framework for project finance and specialised lending should be assessed; while Pillars II and III of prudential regulation could be strengthened with regard to sustainability.

Insurance companies and pension funds: Prudential regulation for institutional investors will also have to be reviewed. For example, consideration of adjusting Solvency II to enable greater investment by insurance companies in sustainable equity and long-term assets should be explored.

Asset managers: As the last stage of the investment and lending chain before capital enters the markets, asset managers are uniquely placed to help capital flow towards more sustainable investments. Embedding sustainability into stewardship codes and asset management agreements, and requiring asset managers to disclose how they integrate ESG factors into their strategy and vote on ESG issues, are all part of the measures that could be pursued to strengthen the ownership chain.

Credit rating agencies and stock exchanges: It is time for long-term sustainability risks and opportunities to move from an ‘add-on’ consideration to a ‘built-in’ feature in ratings. While EU stock exchanges are global leaders when it comes to disclosure of ESG factors, much more can be done to promote sustainability. Exchanges could also support the integrity and growth of the green bond market by encouraging the development and application of robust standards.

Global financial centres: Given European expertise on sustainability, the EU is in an ideal position to take the international lead among such global financial centres. It could establish a network of EU sustainable financial centres to exchange best practices, align standards and achieve market scale.

2. MOBILISING CAPITAL FOR A SUSTAINABLE ECONOMY

Mobilising capital for a sustainable economy requires action on two fronts: the first is shifting the current capital allocation from an unsustainable pathway to a sustainable one; the second is filling the investment gap to ensure that objectives are achieved on time.

Clarity on policy plans: A coherent policy strategy is urgently needed to translate sustainable development ambitions into investment opportunities. Member states need to provide a plan indicating to investors how they intend to mobilise the capital needed to meet their 2030 goals and the long-term climate and energy obligations of the Energy Union and the Paris Agreement.

Sustainability taxonomy: Agreeing an EU classification system of ‘sustainable’ assets would boost investor confidence and give firms a better understanding of which assets qualify as sustainable investments. Establishing a common language also requires appropriation of the EU classification by market participants through its integration into process guidelines and assessment (product and process) standards. A European standard for green bonds, in particular, would help the EU green bond market reach its full potential.

Product standards and labels: The EU should encourage the development of sustainable financial products. This could be pursued by considering new political risk guarantees for sustainable

infrastructure, and support for the development of green and social bond markets, as well as that of new sustainable financial products and services that use technology to deliver sustainable outcomes.

Fostering infrastructure: To support and facilitate these investments, the EU could create 'Infrastructure Europe', a dedicated organisation responsible for developing and structuring infrastructure projects and matching them with investors. This new entity would be responsible for match-making infrastructure projects with investors, focusing on sustainability projects in particular, and help countries in their efforts to access capital markets to finance their capital-raising plans.

Wider society: Last but by no means least, enabling greater engagement of society by increasing literacy on sustainable finance issues, which will stimulate informed demand. The EU should support the creation of a set of publicly available corporate sustainability league tables, ranking firms on their performance against the Sustainable Development Goals. We also recommend the creation of sustainable investment standards at the retail level as a simple way for citizens to demand sustainable investment with impact.

In summary, the early recommendations of the HLEG are to:

- Develop a classification system for sustainable assets
- Establish a European standard and label for green bonds and other sustainable assets
- Clarify that fiduciary duty encompasses sustainability
- Strengthen ESG reporting requirements
- Introduce a 'sustainability test' for EU financial legislation
- Create 'Sustainable Infrastructure Europe' to channel finance into sustainable projects
- Enhance the role of the ESAs in assessing ESG-related risks
- Unlock investments in energy efficiency through relevant accounting rules

3. NEXT STEPS

This Interim Report is intended to provide the basis for fruitful and constructive consultations as the HLEG engages in the next phase of its work. The HLEG welcomes comments, questions and discussions during the process of preparing its final report for publication in December 2017.