ESG AGENDA: EU PRIORITIES

1. EU action plan on financing sustainable growth

1.1. Main features of the action plan of the EU Commission and its progress

A public sector representative stated that sustainable finance is very close to the heart of the European Investment Bank (EIB). It was the first issuer of green bonds in 2007, and since then has issued over 20 billion green bonds.

The sustainable finance agenda is very ambitious and will be encouraged in the new EC. The UN Sustainable Development Goals (SDGs) and other environmental objectives will require trillions in private capital to be mobilised, which is well beyond the means of public financing. Investment in clean energy will have to more than double to almost over 400 billion per year over the course of the 2020s, and to 550 billion in the 2030s. The financial private sector is going to be part of a solution and part of a much broader agenda. President Elect von der Leyen has called on the EIB to position itself as the climate bank of the EU. The EIB's proposal is to phase out its financing of all fossil fuel related energy projects.

A policymaker stated that climate change consists of addressing a crisis. There is an urgent need to move the economy to a sustainable development path although the private sector will finance the transition to the extent that the transition delivers returns. This transition will have massive financing costs beyond what is possible from the public sector, so the industry needs to mobilise and facilitate private financing. One action plan was delivered by the Commission in March 2018, based on technical work done by experts. The experts' recommendations were embedded in the 10 point action plan to mainstream sustainability in the financial system. The objective is to create a framework that allows an investor to develop a preference for green and then to act on that preference. The three early proposals related to a taxonomy, improved disclosures in order to require the industry to display what they are doing in terms of green, and also sustainable benchmarks. The focus is on creating a taxonomy; the Commission expects to have it done by the end of 2019 or very early in 2020.

An industry representative felt that the action plan is an important part of the solution; having the same definitions, it gives a solider foundation in terms of how asset managers, banks and other players can act on this. The taxonomy needs to be dynamic and needs to take into account that there are multiple taxonomies that must converge over time.

A policymaker stated that the taxonomy has to be scientific in its basis, otherwise it is not credible. The legislation in the taxonomy is to do with the governance of the taxonomy. It is going to alter over time, so it is important to get the governance right.

The taxonomy has to be useable by the market and has to have a degree of political acceptance, otherwise it will not be possible to articulate a sustainable finance agenda with the broader economic agenda. Yet, clients are changing their preferences of their own accord; at some point there has to be another set of incentives built into the system. EC's now wider climate agenda – the new Green Deal strategy, will be announced over the next 100 days. Actions have been taken on climate in various parts of the Commission, and the plan is to bring it together into a coherent framework. Sustainable finance is going to be part of the solution and is part of a much broader effort which is bringing all together within the EU Commission 10 15 DGs, led by DG Climate, to work on the 2050 carbon neutrality target and the 2030 targets. This effort is ambitious and is going to have important implications for the way people live.

An IFI representative believed prices are going to be crucial, particularly on carbon pricing, but also on other forms of environmental pricing in terms of guiding investments into the right areas. Until there is adequate carbon pricing and other forms of environmental pricing, the sustainable finance agenda on the table is not facilitating investor choices.

An industry representative stated that the sustainable finance is very important to their bank and welcomes the Commission's action plan for financing sustainable growth. Indeed, it is trying to provide the agents in the market with incentives so that market driven results lead to the internalisation of (climate related negative) externalities. In an ideal world the price of carbon would play an important role however that market is still not sufficiently sophisticated, and from time to time will give the wrong signals to market players. An IFI representative felt that the industry's reaction to the proposals is a broad welcome since this is going to be helpful in facilitating investor preferences. Until there is an adequate price of carbon this is a helpful agenda.

The Commission is working to set up an international platform where it will bring together the regions of the world that wish to work together. It will start as a platform on which views, information and best practice can be exchanged; going forward it will be a forum in which the world can work together to come up with coherent taxonomies that do not lead to immediate fragmentation in the sustainable finance agenda at the international level.

1.2. Industry needs and reactions to the proposals and challenges

An industry representative felt that the role of the asset management industry in this is through engagement with the companies they invest in. If a company has 200 analysts who know the company intimately and are speaking to them every month then they are in a good position to challenge and scrutinise those companies on both their financial performance and their ESG performance. However, when a company does not have such information it is then unknown how it prepares itself for its ESG responsibility. In this respect the passive investment industry will say it fulfils its responsibilities under stewardship through voting, but what is specific here is engagement, not voting, however engagement cannot be done cheaply.

An industry representative acknowledged that active managers can do a great deal to promote sustainable investments, unfortunately a great deal of capital is going into passive investments. Then one question is also whether even in passive investment more cannot be done to make sure that more of that capital is going into sustainable investments.

An industry representative noted that from an asset management perspective their financial group's investment advice has integrated questions around whether the customer wants to have a particular focus on environmental, social and governance (ESG) topics when selecting their investment portfolios. Asset managers will also see that they can channel much of their capital into the sustainable finance area because there is a customer demand there. The group also has separate responsible investment teams when it signed the UN Principles for Responsible Investment (PRI), but has also integrated it into portfolio management.

An IFI representative stated that the EIB Group aims to lead by example in managing its environmental performance and disclosing the impact of its operations. The Group has reported on the environmental impacts associated with its operational activities for over a decade. Last year saw a continued reduction in net emissions per employee, which has decreased by over 50% since 2007. There is a lot of confusion when institutions talk about the sustainable finance taxonomy and Paris alignment, and whether there is a difference, or they are the same. EIB approach builds around three pillars: (i) an increase in its own financing from current levels that stand at nearly 30% of EIB's new commitments worldwide dedicated to climate and environmental goals; (ii) a commitment to grow sustainable finance by working with EIB's public and private partners; and (iii) building on EIB 2015 Climate Strategy, alignment of all the EIB Group's financing activities with the principles and goals of the Paris Agreement. Alignment will determine a change in EIB Group's policies and actions, starting with a pledge to phase out energy projects that depend on fossil fuels.

It is useful that the general approach of the Commission has been to provide transparency through disclosures, benchmarks to players in the marketplace, and a list of the environmental damages or benefits that different technologies and sources of energy produce. The taxonomy provides comparability, which will allow for less greenwashing and will make more investment funds and investment decisions. There is a fear that these taxonomies could become excessively driven by technology preferences. The quality of the data does not allow for very careful incorporation of risk, but it should be part of the conversation with supervisory bodies that banks normally engage with. Pursuing ESG goals is beneficial, and htis has been shown empirically by both academic research and in research by the asset management industry.

A policymaker noted, however, that many institutions are working with inconsistent definitions. The EIB will not allocate its green bond funding to certain energy sectors such as gas or nuclear, but other institutions do. There is a lack of adequate disclosures, so it is not always clear from an investor perspective what exactly is being financed with their investments. These growing consumer and industry concerns have obviously prompted the European Commission and other public actors to set out the agenda, the action plan on financing sustainable growth.

An industry representative stated that in June 2018 their company decided to put its climate strategy totally in line with the Paris Agreement, which is very demanding. The question is whether to follow the sustainable trade or whether it is accelerated in the financial area. The company has governance at the top level of the bank and has also decided to be certified by external auditors. It has decided to assess all its clients in the way they are adapting their own business models with regard to climate change and has decided to adopt the same tool between investment and financing pots. Finally, it has decided to green the balance sheet of the company; this is very demanding because it requires a concrete financing and investing scenario to be adopted. The scenario the company has adopted is the Climate Analytics scenario, which asks it to disinvest coal in 2030 in the European Union, 2040 in China and 2050 in the rest of the world.

The taxonomy is a vital language that has to be adopted. It includes transitional activities and activities which are enabling the achievement of the transition towards the local bond economy, and this is an appropriate approach. However, the Technical Expert Group (TEG) high level report fails to explain clearly how banks could support their clients, because the taxonomy is quite static. In addition, Data is key in the climate transition; banks currently do not have enough data, so they have to persaude corporates to give their data and to be certified as well, because the question regards what it means to be green. Ultimately if the EDF has to state clearly whether they are 20% or 25% sustainable, banks have to take this data as it is.

The TEG proposes to exclude activities on the nuclear side from the taxonomy. A speaker expressed the opinion that this is an error, because the Climate Analytics scenario takes the nuclear to be a tool against climate change. The TEG stated that nuclear energy is outside the taxonomy, pending further scientific studies. The question is what 'scientific studies' means. For banks, this is totally inappropriate and questionable. The same thing is true regarding biogas; biogas is absent from the taxonomy because it is not significant enough to be eligible for the taxonomy. The decisions of the TEG can get very controversial. Nuclear is out and conventional gas is out although many people regard gas as a transition technology; it is better than coal but under the taxonomy it is out.

An industry representative added that their company is not waiting for a taxonomy. It is very important that the regulatory world and public authorities should realise that this market is moving very quickly. Clients are driving this change, not regulation. The active equity industry or the fixed income industry is under intense pressure from substitutions, and the only growth part of the active industry really is in the area of the ESG or sustainability. Five years ago, there may have been a situation where there was a small ESG team which was an addition to the investment process, but at present things are very different. The industry representative's company has close to 200 equity and fixed income analysts and has had to retrain them all. It has redesigned the nature of its investment reports, the questions that it poses to companies, and it has introduced its own proprietary ESG rating system.

It is a market driven agenda driven firstly by clients across Europe, particularly in the north, but it is not just a European phenomenon. Asia is moving quickly, particularly in Japan where the Government Pension Investment Fund (GPIF), has led the Japanese pension system in this direction. This is also taking place in Taiwan and elsewhere. The question therefore is not whether this is a regulatory driven agenda, but how regulation can facilitate this. If done properly, this is where the taxonomy can be of great assistance, because companies have much data at a corporate level on this matter but do not have standards and standardised data. A common language is needed which companies can work to in terms of their non financial disclosure.

1.3. Financial stability and prudential regulation challenges

A Central Bank official stated that regarding the expected impacts on the banking sector, client related issues are gaining a great deal of traction within the community of central banks and supervisors. More peers are convinced that climate related risks are a source of financial risk. The message that was conveyed in the 2018 progress report made it clear that action falls squarely within central bank mandates to ensure financial stability and that the financial system is resilient to this risk. The Network for Greening the Financial System (NGFS) was launched in December 2017, and its membership now consists of 42 members and eight observers. The network covers the five continents and is a coalition of the willing. The idea is to support the transition to a low carbon economy through its rule over the financial system.

The first comprehensive report was released in April 2019, with six high level recommendations. Four apply to the work of central banks and supervisors, while the last two give advice to policymakers. The recommendations are integrating climate risk into micro supervision; integrating sustainability factors into central banks' own portfolio management; bridging the data gaps; building awareness and intellectual capacity; supporting internationally consistent disclosure; and supporting a taxonomy of economic activities. Work remains to be done in order to equip the community with the appropriate tools and methodologies. The first two deliverables are to be released by the end of the first half of 2020, while the last will be hopefully released on the occasion of the IMF World Bank's annual meeting in October 2020.

The biggest challenge is good quality data, because different data providers will typically give very different answers. An important part of what this taxonomy will help with is improving the data. The question, however, is how companies are going to turn a 300 400 page taxonomy into something that enables equity analysts to pick stocks for investors depending on their sustainable finance preferences.

A Central Bank official believed that the sector is currently at the beginning of the process. If it wants to change the capital requirements, it needs to have a good basis for that, which means that it needs to check whether green assets are less risky than brown assets. The idea is not to act and change capital charges, but the sector would like to introduce new expectations from the supervisors in the way that banks manage these risks.

An industry representative stated that when their company started integrating sustainability into its asset management there was a belief that it would actually be positive for risk management but would hurt returns. Over time it has been empirically seen that returns have been even better from many of the products where this has been taken into account. Firms that will make the right choices will give great performance to the investments that they make for their unit holders. In that sense, being able to see who is good and who is not over the next couple of years will have a big impact on active returns.

An industry representative stated that asset managers are interested in value creation, which encompasses short term profitability. What dominates net present value are terminal values. Focus is needed on intangibles, otherwise terminal value will not be priced correctly. Whilst there may be a trade off between short term profitability and sustainability, there is not a long-term trade-off between value creation and sustainability because terminal values, by definition, are sustainable.

2. Further incentives toward an effective contribution of the frameworks to EU climate targets

A policymaker explained that the EU framework will be strategy and will not be executed from Brussels. Three things might need to be done; the price of carbon, environmentally harmful subsidies, and taxation. There is a need to have a sustainable finance agenda which is going to click into a shift in relative prices, because investors are not going to invest in technologies that do not have demand. And there has to be a return. The discussion is about a Green Deal which tries to shift relative prices, as well as to internalise the (negative) externalities. In that environment having a private sector financing arm will be very powerful because then the money will flow.

A market expert noted that it is important to fund the policy against climate change, but there first needs to be a significant flow of investment in the energy transition. To make it high enough, durable and rising, an appropriate level for the price of carbon is the best incentive, according to all economists, since it will trigger investment in clean energy and in all activities that emit less carbon. Since the last Eurofi (Bucharest) meeting there has been a European election which showed that the environment was at the forefront of the preoccupations of the citizens of Europe. Global warming is now high on the agenda everywhere, including the next Commission. Concerning the taskforce that was created, their organisation has taken the initiative, with a group of high level Chinese personalities, of promoting a convergent price of carbon between China and the European Union. They will convene in New York the following Sunday at the Climate Action Summit and will make public a joint declaration of their commitments for a significant price of carbon, both in China and the European Union.

Regarding the taskforce focused on Europe, the objective is to gather more and more people around this device to fight global warming. Progress is extremely rapid. A coalition of finance ministers for climate action, which includes the UK, France, Germany and a majority of finance ministers, signed a declaration in February 2019 the third commitment of which is 'To work towards measures that result in innovative carbon pricing.' In Germany the government is now looking at the domestic price of carbon. The sector is not covered by the Emissions Trading System (ETS), which are transportation and construction. It is clear that there is momentum for introducing a carbon pricing device in Europe.

A policymaker believed that Vice President Timmermans has the overall responsibility for the Green Deal and under him will be DG Climate, which will coordinate this. The Commission will remain responsible for the sustainable finance agenda, but the President Elect states that it will all be about teamwork.

A market expert stated that the new President of the European Commission made it clear that the environment and climate were a priority in her platform. It is clear that she is committed to act decisively in the new Green Deal. The price of carbon on the Emission Trading System (ETS) market is now €25 per tonne, a level which starts to be significant but is still very volatile. In 2008/09 and the recession, the price of carbon decreased from €30 per tonne to €3 per tonne in a matter of weeks. Another collapse of the price of carbon cannot be excluded; consequently, there needs to be a floor on the price of carbon at the current level of €25 per tonne. This measure is easy to implement as it is at the disposal of the Market Stability Reserve (MSR). There is no political cost. The current level of €25 per tonne does not raise any opposition, so nobody would dare to object to the fact that the EC intends not to let this powerful price signal slip below this current level.

An IFI representative questioned whether there is a trade off between the agenda and a return on capital. An industry representative felt that there would not be in the long run, but a market expert felt that until environmental damage is properly priced unsustainable activities will inevitably be more profitable than sustainable activities. An industry representative is worried by this focus, as these types of decisions are going to imply huge changes in the landscape of the relative importance of different industries in various societies. The discussion has not incorporated the critical dimension, which is that this transition should take into account who wins and who loses. Losers have to be compensated and cannot be compensated with open ended schemes. Being neutral on technology has to be complemented with being careful about stigmatising certain industries which therefore enter into decline.

A market expert stated that there is no time for a trade off. The device, which is the price of carbon, needs to be put in place, which makes returns in terms of financial investment and real investment in accordance with the success of the energy transition. Returns have to be in accordance, and the only way to do that is the price of carbon. The implementation is complicated, but work has already started. There is a price of carbon in Europe, but the problem is that the European authorities do not want to target the price of carbon because they target the volume. Consequently; the price signal does not play its role, which is absurd. Countries have been in the direction of a price of carbon with much success, such as the UK and Sweden. The question is why it is not done at the European level. The start should be to put a floor on the price of carbon at the level it has to take, which is €25 per tonne, which would be a huge progress in terms of returns from good investments, while the banks and investors will realise that putting their money in coal may be problematic in the long run.