Sustainable finance and disclosures

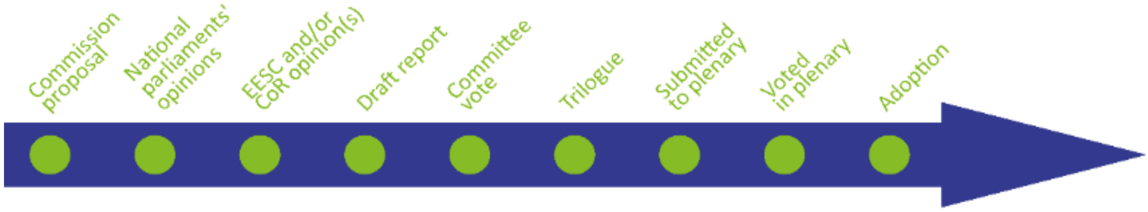
Bringing clarity to investors

OVERVIEW

On 24 May 2018, the Commission published three proposals for regulations reflecting the EU's efforts to connect finance with its own sustainable development agenda. The proposals include measures to: create an EU sustainable finance taxonomy; make disclosures relating to sustainable investments and sustainability risks clearer; and establish low-carbon benchmarks. In particular, the proposal for a regulation on disclosures aims to integrate environmental, social and governance considerations into the decision-making process of investors and asset managers. It also aims to increase the transparency duties of financial intermediaries towards final-investors, with regard to sustainability risks and sustainable investment targets. This should reduce investors' research costs as regards sustainable investments and enable easier comparison between sustainable financial products in the EU. Following agreement with the Council in trilogue, Parliament voted to adopt the agreed text at first reading on 18 April 2019. Because of the tight timeline for finalisation before the end of the parliamentary term, linguistic corrections to the voted text were needed. Under the corrigendum procedure, the ECON committee and subsequently the plenary endorsed the corrected text in October 2019, allowing the Council to adopt it at first reading. Signed on 27 November, the regulation entered into force on 29 December, and will become applicable as of March 2021.

Proposal for a regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341

Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2018) 354 24.5.2018
Rapporteur:	Paul Tang (S&D, the Netherlands)	2018/0179(COD)
Shadow rapporteurs:	Sirpa Pietikäinen (EPP, Finland) Syed Kamall (ECR, United Kingdom) Lieve Wierinck (ALDE, Belgium) Matt Carthy (GUE/NGL, Ireland) Molly Scott Cato (Greens/EFA, United Kingdom)	Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')
Procedure completed.	Regulation (EU) 2019/2088 OJ L 317, 9.12.2019, pp. 1-16	



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Introduction

In alignment with the 2016 Paris Agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the European Union (EU) is committed, among other things, to contributing to the global efforts to make the economy more sustainable.

Achieving sustainability goals requires major investments. It is estimated that an additional annual investment of €180 billion will be needed by 2030 to meet climate and energy targets alone.[1] A substantial part of this money will have to come from the private sector; in other words, it will be necessary to redirect large volumes of private finance towards more sustainable investments.

In this context, the 2017 mid-term review of the capital markets union (CMU) action plan focused on mobilising European savings by encouraging the private sector to make such sustainable investments. The action plan for financing sustainable growth, launched by the European Commission on 8 March 2018, laid out a roadmap to fulfil this commitment.

The proposal for a regulation on disclosures relating to sustainable investments and sustainability risks (COM(2018) 354) is linked to Action 4 (incorporation of sustainability into advice given to the end investor) and Action 7 (incorporation of sustainability into investment portfolios and proper disclosures) of the above-mentioned action plan.

The proposal aims to increase the attractiveness of sustainable investments by requesting the disclosure of more information on the sustainability of investment portfolios, both in terms of composition and risks. Being a part of the Commission's legislative package on sustainable finance, the proposal would also help establish an EU framework aimed at giving greater consideration to environmental, social and governance (ESG) factors when taking decisions on investments.

Context

Sustainable finance generally refers to the process of taking due account of ESG[2] factors (see Table 1) when making decisions regarding investments, in order to render them more sustainable.[3]

Table 1 – Environmental, social and governance (ESG) factors

Source: UN-backed principles for responsible investment (UNPRI).

Among experts, there is a growing consensus that the consideration of ESG factors is compatible with fiduciary duties, when: ESG factors have a financial material impact on the investment performance or valuation; it is reasonable to assume that the taking of ESG factors into account is supported unanimously by the beneficiaries; and ESG factors are a distinctive element when comparing investments with otherwise similar characteristics.

While there are no legal barriers to integrating ESG factors in the investment process applied by entities, many of them do not consider these factors in a consistent way, and the number of those that do consider ESG factors is increasing only slowly. Overall, the level of integration of ESG factors remains moderate, despite an increasing awareness of their importance.[4]

Existing situation

ESG factors should be integrated in investors' investment decisions and the advice offered to them by providers of financial services, such as asset managers, insurance companies, occupational pension funds or financial advisors.

However, the current disclosure requirements set out in EU legislation do not envisage disclosing all of the information necessary to properly inform end-investors (citizens investing in bonds, pension funds, investment funds and other financial products), about the sustainability-related impact of their investments. Furthermore, Member States have adopted different national measures with regard to disclosure requirements.[5] This patchy situation is further complicated by the parallel development of market-based practices[6] that are based on commercially-driven priorities and standards. Such divergences are confusing for end-investors and can distort their investment decisions. Lack of harmonised rules relating to ESG factors and their transparency makes it difficult for end-investors to effectively compare different financial products and services in different Member States.

The current regulatory regime for financial products established by Directives 2009/65/EC, 2009/138/EC, 2011/61/EU, 2014/65/EU and (EU) 2016/2341 requires institutional investors and asset managers to act in the best interests of their clients and to provide scope for integrating sustainability risks both in their investment decisions and in the disclosures processes. However, it does not require institutional investors and asset managers to systematically consider and integrate those risks in a consistent way.

The above regulatory regime is complemented by distribution rules, including on advice, which are laid down in Directives 2014/65/EU and (EU) 2016/97. These directives require investment firms and insurance intermediaries providing advice to act in the best interest of their clients, but they do not require them to explicitly consider ESG risks in their advice nor to disclose those considerations.

Directive (EU) 2016/2341 was a first step towards a more concise disclosure framework in the financial services sector in relation to ESG factors, but it is limited to the activities of the institutions for occupational retirement provision (IORPs).

Directive (EU) 2017/828 increased the transparency obligations of institutional investors and asset managers by requiring them to develop and disclose an engagement strategy, including a description of how they monitor investee companies for their non-financial performance, social and environmental impact and corporate governance, and to disclose how their engagement policy has been implemented on an annual basis.

Nevertheless, according to the Commission, there is still a lack of transparency on how institutional investors, asset managers and financial advisors consider sustainability risks in their investment decision-making or advisory processes.

Comparative elements

There is generally a lack of coherence in the prevailing national legal obligations on ESG disclosures.[7]

Only a small group of countries (France, Denmark and Italy) impose disclosure requirements on all relevant groups of investors: pension funds, insurance companies and asset managers. Although countries like France and Denmark impose the same disclosure requirements on all entities involved, cross-country variations in disclosure requirements remain.

A second group of countries only regulates pension funds (these generally have long-term investment policies), for which ESG risks are more relevant. Legal obligations for pension funds exist in Germany, the Netherlands, Spain and the United Kingdom, while Belgium requires asset managers (but not pension funds or insurance companies) to clarify to what extent ESG factors are taken into account in the implementation of their investment policy.

Finally, countries like Austria, Luxembourg, Portugal and Sweden place no legal obligations on any institutional investors or asset managers. Yet, it should be noted that the IORP II Directive requires Member States to ensure that entities covered by it disclose the relevance and materiality of ESG factors. As the transposition deadline was January 2019, not all Member States will necessarily have fully implemented those rules.

Parliament's starting position

On 29 May 2018, the European Parliament adopted a resolution on sustainable finance. Members of the European Parliament largely supported the Commission's action plan on sustainable finance, agreeing on the essential role of the financial sector as regards sustainability as well as on the need of policies to correct market failures.

The Parliament stressed that the financial sector, in its core function of allocating capital, should include ESG indicators in investment analysis and investment decisions. It furthermore pointed out that the inaccurate assessment or the misleading presentation of climate and other environmental risks of financial products can constitute a risk to market stability.

Moreover, the Parliament noted that sustainability indicators already exist but lack harmonisation. It also noted that voluntary reporting practices are not homogeneous. It called therefore for the Commission to draw up a harmonised list of sustainability indicators and transparency duties.

The Parliament also emphasised that the identification, management and disclosure of ESG risks are an integral part of consumer protection and financial stability, and should therefore fall under the mandate and supervisory duties of the European supervisory authorities.

Preparation of the proposal

In December 2016, the Commission established a high-level expert group (HLEG) to develop a comprehensive EU strategy on sustainable finance. In its final report, the expert group issued eight key recommendations. One of these was to define institutional investors' and asset managers' duties regarding sustainability, and to improve disclosures.

From November to December 2017, the Commission collected stakeholders' feedback on its inception impact assessment of institutional investors' and asset managers' duties regarding sustainability. Most respondents commented on issues such as transparency and disclosure, supervision of ESG integration, clarity of investors' duties in the existing EU legislation, comparability and reliability of available data, risk management and governance arrangements.

From January to February 2018, the Commission also conducted targeted interviews with stakeholders, more specifically medium-sized/large asset managers and institutional investors (insurance companies and pension funds) that had already integrated ESG factors in their investment decision-making process and/or had socially responsible investment products.

Furthermore, the Commission carried out an impact assessment, which it published in May 2018. EPRS is preparing an initial appraisal of that impact assessment.

The changes the proposal would bring

The proposal for a regulation on disclosures (COM(2018) 354) amends Directive (EU) 2016/2341. Furthermore, the disclosure rules contained in the proposal should supplement the provisions of Directives 2009/65/EC, 2009/138/EC, 2011/61/EU, (EU) 2016/2341 and Regulations (EU) No 345/2013 and (EU) No 346/2013.

The aim of this proposal is to introduce mandatory disclosure in order to reduce the asymmetry of information between financial entities and end-investors. Harmonised rules on transparency would be applied by financial market participants, both in the investment decision-making process and the advisory process. According to the Commission, end-investors would benefit from lower search costs in finding financial products and/or services corresponding to their sustainability preferences, and consequently the market for such products and services should grow. Transparency would be enhanced with regard to several aspects and through different channels. Financial market participants would be asked to publish their policies on integrating sustainability risks in the investment decision-making process or advisory process (Article 3), on their websites.

With regard to pre-contractual disclosures (Article 4), financial market participants, being either investors or investment advisors, should describe: the procedures and conditions applied for integrating sustainability risks in investment decisions; the extent of the expected impact of sustainability risks on the return generated by the financial products; how their remuneration policies are consistent with sustainability risks integration and targets.

The proposal would also enhance the transparency of financial products targeting sustainable investments and having an index as a reference benchmark (Article 5). In pre-contractual disclosure, it would be necessary to provide information on how the designated index is aligned with the financial product sustainability target and to explain why this index differs from a broad market one.

With regard to the different channels for ensuring the transparency of sustainable investments, financial market participants would be asked to publish and maintain information related to each financial product they offer, on their websites (Article 6). The periodic reports they generate would also be a further channel of transparency (Article 7.)

The proposal would also require financial market participants to keep the information disclosed up to date and to clearly explain any changes made to such information (Article 8). Furthermore, financial market participants would be required to ensure that marketing communications will not contradict the information disclosed (Article 9).

Through Article 10, the proposal would also amend Directive (EU) 2016/2341 in order to include ESG factors in internal investment decisions and risk management processes, and to take into account the 'prudent person' rule with respect to ESG risks.

Advisory committees

On October 2018, the European Economic and Social Committee adopted an opinion on the proposal. The Committee welcomes the aim of harmonising the rules to be followed by institutional investors and asset managers during the investment process, requiring them to take into account sustainability risks and factors and to introduce a level of transparency that would enable making an objective comparison between sustainable financial products.

During its October 2017 plenary session, the European Committee of the Regions adopted an opinion on Climate finance: an essential tool for the implementation of the Paris Agreement, in which it assigns priority to raising investors' awareness of the risks and opportunities linked to climate change – considering it a factor that would encourage them to start making more sustainable investments – and welcomes the June 2017 final recommendations report of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD)

National parliaments

The subsidiarity deadline for national parliaments to submit comments on the proposals was 24 September 2018. The Spanish parliament sent a contribution on 3 October 2018, in which it expressed the opinion that the proposal is respecting the subsidiarity principle.

Stakeholders' views[8]

The European Fund and Asset Management Association (EFAMA) welcomes the Commission's focus on disclosure/transparency, while at the same time providing a number of recommendations. Some of these involve: balancing the level of disclosure needs with the materiality/relevance of the information provided to investors; clarifying the link with the taxonomy proposal (COM(2018) 353), particularly in terms of aligning definitions; introducing a longer transition period; and encouraging policy-makers to consider the bigger picture in relation to the fragmentation of rules.

EuropeanIssuers, in its position paper on the Commission's Action plan on sustainable finance, makes some key recommendations: adopting a flexible approach based on voluntary initiative and experimentation; fully engaging listed companies in the debate; finalising the Fitness check on public reporting by companies before proposing any new corporate reporting measures; ensuring a level playing field between EU and third-country companies; and carefully drafting new obligations regarding investors' duties to respect the principle of free investment, while encouraging sustainable finance.

Accountancy Europe, in its position paper on sustainable finance, focuses on how accounting frameworks can produce comparable and consistent information for sustainable long-term investments. In this regard, the Commission should consider the above-mentioned recommendations of the TFCD at EU level, and the Non-Financial Information (NFI) Directive should be aligned accordingly.

In its comments to the Final report of the High-Level Expert Group on sustainable finance, Finance Watch suggested, echoing other stakeholders, that the recommendations of the TFCD be endorsed by the EU and made mandatory. It furthermore pointed out that the Commission should investigate whether alternative accounting approaches to fair value/mark-to-value valuation for long-term investment portfolios of equity and equity-type instruments are needed to promote long-term sustainable investments.

Better Finance, in its position paper on the proposal, voiced concern regarding the consistency between the proposal on disclosure and the proposal for an EU taxonomy, and regarding the timeline of implementation of the proposal on disclosures. It furthermore expressed regret that the Commission had not defined the term 'sustainable risk' in Article 2 of the proposal on disclosure and drew attention to the multiplication of delegated acts. Last but not least, it highlighted the need to describe in greater detail in Article 4 the extent to which sustainability risks are expected to have a relevant impact on the returns of the financial products made available.

Legislative process

The legislative proposal (COM(2018) 354) was presented on 24 May 2018. It falls under the ordinary legislative procedure (2018/0179(COD)). In the Parliament, the dossier was assigned to the ECON committee. The EMPL, ENVI and FEMM committees were invited to give their opinions.

The ECON rapporteur, Paul Tang (S&D, the Netherlands), published the draft report on 2 August 2018. ENVI provided its opinion on 11 October 2018, while EMPL and FEMM decided not to give an opinion. ECON adopted its final report on 5 November 2018. On 14 November 2018, the Parliament confirmed the ECON committee’s decision to enter into interinstitutional negotiations. In December 2018, the Council’s Permanent Representatives Committee agreed the Council’s mandate for negotiations with the Parliament. After five trilogue meetings, on 7 March 2019, the Romanian EU

Council Presidency and the European Parliament reached agreement on a compromise text. Parliament adopted its first-reading position on the basis of that agreement in plenary on 18 April 2019. Because of the tight timeline for finalisation before the end of the parliamentary term, linguistic corrections to the voted text were still needed.

The compromise text made a number of changes to the proposal of the European Commission.

Article 1 enlarges the scope of the regulation, by requiring that the set of rules on transparency with regard to financial products should not only concern the integration of sustainability risks, but also include consideration of adverse sustainability impacts in their processes, and should provide sustainability-related information on financial products. The rules will also be applied to financial advisers.

In article 2, the list defining the financial market participants for which the regulation applies is extended. Amongst others, credit institutions which provide portfolio management are included.

Article 3, on transparency of sustainability risk policies, is enriched by including the concept of transparency of adverse sustainability impacts at entity level. An important change is introduced through article 3a, where the transparency of remuneration policies in relation to the integration of sustainability risks is increased.

In article 4, with regard to pre-contractual information transparency on sustainability risks stemming from a financial product should be increased. Additional information on the manner the assessment was taken into account in investment decisions will need to be provided also in those cases where sustainability risks are deemed not to be relevant. A clear and concise explanation why they are not deemed relevant is required. Transparency in relation to the promotion of environmental or social characteristics in pre-contractual disclosures is improved.

In article 6, which concerns the transparency of sustainable investments on websites, it specifies that the information published on websites must be accurate, fair, clear, not misleading, simple and concise, and easily accessible in a prominent part of the website.

In article 7, dedicated to transparency in periodic reports, it is required to add the description of the extent to which environmental or social characteristics are attained by a financial product for some products, or for others to use relevant sustainability indicators to gauge the overall sustainability-related impact of the financial product.

Following a corrigendum, the corrected text was endorsed by first the ECON committee, and then Parliament's plenary in October 2019. This enabled the Council to adopt the agreed text at first reading. The regulation was signed on 27 November, and came into force on 29 December 2019. Most of its provisions will be fully applicable from 10 March 2021, apart from certain requirements for the periodic reports on financial market products which will apply from 1 January 2022.

EP SUPPORTING ANALYSIS

S. Vettorazzi, An EU framework to facilitate investments in environmentally sustainable economic activities, initial appraisal of the Commission IA accompanying the legislative package, EPRS, European Parliament, April 2019.

OTHER SOURCES

Disclosures relating to sustainable investments and sustainability risks (2018/0179(COD)), European Parliament, Legislative Observatory (OEIL).

Directive (EU) 2016/2341, 14 December 2016.

Resolution of 29 May 2018 on sustainable finance (2018/2007(INI)), European Parliament.

Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks COM(2018) 354, European Commission, 24 May 2018.

Impact assessment accompanying the proposal on the establishment of a framework to facilitate sustainable investment (SWD(2018) 265), European Commission, 24 May 2018.

Final report of the High-Level Expert Group on Sustainable Finance, January 2018.

Financing Sustainability: Triggering Investments for the Clean Economy, European Political Strategy Centre, June 2017.

Integrating Climate Change-related Factors in Institutional Investment, background paper, OECD, February 2018.

Investing for the common good: a sustainable finance framework, essay and lecture series, Bruegel, July 2017.

Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures, Task Force on Climate-related Financial Disclosures (TFCD), June 2017.

Making Waves: Aligning the Financial System with Sustainable Development, Inquiry team, UN Environment Programme (UNEP), April 2018.

The principles for positive impact finance – a common framework to finance the sustainable development goals, UNEP, January 2017.

ENDNOTES

1 The estimate is a yearly average investment gap for the period 2021-2030, based on PRIMES model projections used by the European Commission in its 2016 Impact assessment (SWD(2016) 405 final) accompanying its proposal to amend the Energy Efficiency Directive.

2 Although there is no definitive list of issues or factors that are covered by 'ESG considerations', they are – according to a United Nations Environment Programme (UNEP) inquiry and the principles for responsible investment (PRI) – broadly defined as follows: environmental (E) issues relate to the quality and functioning of the natural environment and natural systems; social (S) issues relate to the rights, well-being and interests of people and communities; and governance (G) issues relate to the governance of companies and other investee entities.

3 This would require that sustainability risks are always taken into consideration when making investment decisions, and not only when sustainable impact investments are selected on the basis of very explicit sustainability preferences expressed by investors. In fact, investors can invest sustainably either by integrating ESG factors/risks in their investment decision-making (which usually minimises the ESG risks), or by investing directly into economic activities that positively contribute to sustainability (which usually maximises ESG benefits).

4 See SWD(2016) 405 final, p. 18, Box 2.

5 The European Commission Impact Assessment of 24 May 2019 (SWD(2018) 264 final), p. 153, Table 33, gives an overview of the legislative initiatives within the domain of socially responsible investments (SRIs), by country.

6 Ibid., p 156, Table 34 gives an overview of market-led initiatives within the SRIs, by country.

7 Ibid., pp. 24-25, Table 1 presents a summary of the various national legal obligations regarding SRIs and ESG disclosures for a selected group of Member States.

8 This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.

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