European Parliament Brussels, ECON Public Hearing on Sustainable Finance

Statement from Eric Usher[1], Head, UNEP FI

Twenty-five years ago, a small group of forward-looking banks and insurers meeting on the sidelines of the 1992 Earth Summit in Rio de Janeiro realised that the finance industry had a key role to play in shifting the planet to a more sustainable footing. During this meeting, they conceived of a UN – finance sector partnership that became the UNEP Finance Initiative. I have the privilege to head this organisation, UNEP FI.

In the quarter of a century since its creation, UNEP FI has helped to firmly embed environmental, social and governance considerations into financial practice. In 2006 with Kofi Annan and the UN Global Compact we established the Principles for Responsible Investment (PRI) which, with nearly 70% of institutional investment globally now signed up, is the world's leading proponent of responsible investment. In 2012 with Ban Ki-moon we launched the Principles for Sustainable Insurance (PSI) which today is endorsed by insurers representing 25% of world insurance premium. Learning from PRI, the PSI have become the global framework for integrating ESG risks and opportunities into the core business of insurance. Meanwhile, through the UN Sustainable Stock Exchanges Initiative which UNEP FI co-convenes with PRI, UN Global Compact and UNCTAD, 68 of the world's most important stock exchanges are working to integrate sustainability considerations into corporate governance practices, reporting requirements and credit rating assessments.

Even as the financial sector has made quite some sustainability progress since 1992 in Rio, our society and the natural environment have seen changes that even our prescient founding members could not have foreseen. While there has been indisputable progress in the fight against extreme poverty, globalisation and the inter-connectedness of our world have also nurtured socio-economic imbalances and political unrest, spurring the greatest migrations of our times. Meanwhile, we have crossed the thresholds of various planetary boundaries. 2017 was the second hottest year on record, surpassed only by 2016, and the catastrophic weather events of this past summer—hurricanes Harvey, Irma and Maria, and the extreme flooding in parts of Asia—have claimed lives, livelihoods and caused hundreds of billions of dollars in damage.

And the new risks and potential liabilities are not just climate-related. Profligate use, and inadequate management, of limited natural resources may soon begin to cause serious difficulties for global supply chains: during the last century, the planet has lost 50% of its wetlands, 40% of its forests and 35% of its mangroves.

With so much uncertainty, sustainable finance is at a critical juncture. The sector's ability to assess and manage environmental social and governance issues needs to shift gears towards forward-looking risk management approaches that can address the transition risks associated with a shift to sustainable low carbon and climate resilient economies. And we need to look beyond risks and also focus on growing the pool of finance available to deliver positive impacts. With the UN Sustainable Development Goals agreed, financiers will increasingly need to take a more holistic approach to extra-financial analysis, appraising both positive and negative impacts and doing so across the three pillars of sustainable development. By doing this, we're preparing for an economy where impacts will become much more central, and developing a common language for all actors needing to identify truly positive impact, SDG-serving, business and finance.

At such a critical juncture, the work of the High Level Expert Group on Sustainable Finance is extremely timely. The HLEG report is a very rich document, standing alongside China's work as perhaps the most comprehensive effort to date to make sustainability part of core financial architecture. European Commission aims to put achieving a sustainable financial system at the heart of financial reform is highly important if the global commons are to be restored and Europe is to lead the transition to a more sustainable economy and society.

[1] *The views and recommendations expressed in this statement are those of the UNEP FI Secretariat and do not necessarily represent the views of UNEP FI governance bodies or member institutions.*

With that opening, I would now like to provide feedback on some of the HLEG recommendations and suggest possible considerations for the EC Sustainable Finance Action Plan taking into consideration the Draft Report on Sustainable Finance (2018/2007(INI)) prepared by the Committee on Economic and Monetary Affairs.

Overall we find the HLEG report an exemplary set of recommendations that if implemented wholly offer the potential for a significant uplift in the European financial industry approach to sustainability integration. The following feedback should be seen as possible ways to strengthen the recommendations on some specific issues, not as proposals for radically different approaches.

SCOPE AND STAKEHOLDERS

Although the initial scope of the HLEG report is sustainability overall and contains references to ESG factors and the SDGs, as the authors themselves acknowledge, in its current status the recommendations focus on the 'green' component, and within green mostly 'climate' – and even then mostly on the greenhouse gas mitigation agenda, and hardly on adapting to the physical impacts of climate change. Sustainable finance is not merely an internal instrument, to address issues strictly within the borders of the EC. It is a key instrument to address pressures coming from the outside – immigration, insecurity, food security. The developmental pillar of the SDGs is completely absent from the paper, and social issues are considered only locally.

Regarding stakeholders, as banks play a key role in Europe's financial architecture the absence of banking representation on the HLEG and its process is a concern.

Regarding the scope of the exercise and its stakeholders, we recommend:

- *That it is important for the EC to evaluate the scope and level of ambition it wishes to pursue with 'sustainable finance'.*
- *That banks be involved more closely in the follow-up actions of the Commission.*

TAXONOMY

The call for a taxonomy is what comes closest to a unifying element and overarching framework for the report as a whole. The proposed taxonomy, which is to gradually address a number of sustainability topics, starting with climate change, is sector-based. In other words, the identification as sustainable of specific activities, technologies and sectors. Even with regular efforts to expand and update such a taxonomy, the sector-based approach will be useful mainly in redirecting flows between existing and already proven business lines and sectors. Yet major technological and economic disruptions are underway and such an approach may have trouble keeping up with change and ensuring that the EC is in a trend-setting rather than a reactive position.

In an increasingly service-based and technologically enhanced economy, tomorrow's business models and companies will in fact be more impact-based: they will specialize in mobility rather than selling cars, in energy efficiency rather than building power plants, in education and health, etc. We believe the next step in ESG analysis is for financiers to take a more holistic approach to extra-financial analysis, appraising both positive and negative impacts and doing so across the three pillars of sustainable development. By doing this we're preparing for an economy where impacts will become much more central, and offer a common language for all actors needing to identify truly positive impact, SDG-serving, business and finance.

A group of UNEP FI banks and investors have been working to develop this notion of Positive Impact Finance. We will be pleased to keep the Commission abreast of its progress with establishing the framework for Positive Impact Finance and in this respect we are happy to see the approach already included in your Draft Report for inclusion in the taxonomy.

Regarding the proposed taxonomy, we recommend:

- *Considering inclusion of the Positive Impact Finance approach in the proposed taxonomy, an impact-based approach that takes impacts as the starting point rather than sectors or technologies.*

FIDUCIARY DUTIES

UNEP FI’s work on fiduciary duty goes back to 2005 when we commissioned the first report on this topic, called the Freshfields report, that led to the creation of the Principles for Responsible Investment. More recently we’ve engaged with over 400 policy makers, regulators and investors from 15 jurisdictions through the project ‘Fiduciary Duty in the 21st Century’, on the basis that the law in many countries is not sufficiently clear, and that more explicit signals from policymakers are required when it comes to environmental, social and governance issues.

The HLEG report sends a clear message that acknowledging environmental and social factors is a critical component of investor duties, which are essential to investment processes. In fact, the very notion of fiduciary duty demands that any issue potentially material or affecting financial performance be duly processed and integrated in an investment decision making process. That includes environmental and social issues.

Although investor duties are codified in European financial services edicts (MiFID II, AIFMD), the HLEG report cautions that they “do not factor in sustainability to the level required”. Echoing the HLEG recommendations on investor duties, we strongly encourage that investor duties be clarified in the European Union. As identified in the HLEG recommendations, we also support for pension fund trustees to engage more and better understand the broad range of interests and preferences of their members and beneficiaries, including on sustainability issues. The current disconnect between fiduciaries and their beneficiaries create potential misalignments across the investment chain – including the risk for these trustees to fail on their duty to invest in the best interest of their beneficiaries, workers and citizens.

Regarding fiduciary duties:

- *We fully support the proposed approach put forward in the HLEG report and feel it is promising to see the European Commission moving forward on this important topic.*

INSURANCE

The core business of the insurance industry is to understand, manage and carry risk. UNEP FI’s Principles for Sustainable Insurance (PSI) encompasses the triple role of the insurance industry in sustainable development as risk managers (physical risk management), risk carriers (financial risk management) and institutional investors (asset management). In comparison, the HLEG recommendations largely focus on the investor role of insurers.

As risk managers, insurers help communities understand, prevent and reduce risk through research and analytics, catastrophe risk models, and loss prevention. Insurers also advocate proper land-use planning, zoning and building codes, ecosystem-based disaster risk reduction, and disaster preparedness. In this regard, the EU financial system could benefit from the expertise of the insurance industry in areas such as catastrophe risk modelling which could better inform areas such as scenario analysis and disaster risk management.

As risk carriers, insurers protect households, businesses and governments by absorbing financial shocks due to risks such as cyclones, floods, droughts, earthquakes, accidents and illnesses. Insurance pricing also provides risk signals and rewards risk reduction efforts. Insurance solutions for renewable energy, energy efficiency, green buildings and usage-based insurance for vehicles enable the transition to a green economy.

Sustainability issues are increasingly being embedded in core insurance company activities. For example, the PSI is carrying out an initiative to develop global guidance on the integration of ESG risks into insurance underwriting—the process of evaluating, defining and pricing insurance risks—across lines of insurance business.

Regarding the role of insurers, we recommend:

- *Looking beyond insurers role as investors and also exploring the role that their risk manager and risk carrier roles can play in supporting the transformation to an inclusive, resilient and sustainable economy;*

- *Promoting the application of ESG guidelines for insurance underwriting t help prevent and reduce business transactions that damage the environment, negatively impact communities, and involve poor governance practices.*

HUMAN RIGHTS

On human rights, a significant shift has been happening in recent years. The UN Guiding Principles on Business and Human Rights (UNGPs) constitute the authoritative global standard setting the expectation for businesses, including financial institutions, to respect human rights. On the one hand, the EC is committed to the UNGPs implementation (i.e. EC Action Plan on Human Rights and Democracy 2015-2019) and European financial institutions – investors and banks alike - are actively engaged in processes on clarifying what the UNGPs mean for them in practice. On the other, this important agenda is not reflected in the HLEG report and risks being omitted in the design of EC policy frameworks on sustainable finance. This would lead to fragmentation in policy and signals to the private sector.

On human rights, we recommend:

- *Recognizing human rights as integral and core to the sustainable finance agenda;*
- *Spelling out and clarifying the expectation for businesses – financial institutions and the wider corporate sector – to respect human rights, as set by UN Guiding Principles on Business and Human Rights, in line with EC public commitment to this agenda;*
- *Building on progress achieved with UNGPs interpretation (UN & the OECD), and implementation by European governments, financial institutions and corporates alike;*
- *Ensuring market consistency by not treating human rights as a separate and secondary topic when introducing a common sustainable finance taxonomy.*

ON ENERGY EFFICIENCY AND SUSTAINABLE INFRASTRUCTURE

The buildings sector needs to reduce its carbon emissions over three quarters by 2050 globally which will require investment of roughly USD 300 billion annually. For banks and investors to scale up their financing for energy efficiency, they will need to develop internal systems for tracking the green or sustainable attributes of financing.

Although not typically considered infrastructure principally due to small investment size and split ownership, the long-life nature of buildings and 'lock-in' in terms of carbon and resource use shares similarities with the infrastructure sector. And buildings are becoming essential parts of dynamic, distributed energy networks which can be aggregated across large numbers of small individual assets and entered into network planning for energy services.

On energy efficiency and sustainable infrastructure, we recommend:

- *Consideration that green tagging, mentioned in the energy efficiency section of the HLEG report, be more explicit in that this tagging is not a one-time event at the time of origination. Particularly for green tagged home mortgages that are securitised, capturing information on energy performance on an on-going and post-issuance basis will also be needed.*
- *Including building related issues in the mandate of Sustainable Infrastructure Europe, making it a potential target area for capacity building and project development support of this entity.*

IN CONCLUSION

Clearly there is still a long road ahead to a sustainable and resilient global economy supported by a sustainable financial system. In future, progress will be about a fuller-scale institutional re-alignment with sustainable development, scaling up the green, but also turning down the brown, and having the leadership, the management, the products and value chains in place to turn the ship.

We commend the leadership effort that the High Level Expert Group has made, and the foresight of the European Commission and Parliament in endeavouring to make the financial community fit for purpose for the challenges of financing sustainable development.

Action is critical. In the words of Henri de Castries, former Chairman & CEO, AXA, “A 2°C world might be insurable (but) a 4°C world certainly would not be.”