Eurosif Policy Position on the Capital Markets Union Action Plan

General remarks

As macrotrends such as climate change and natural resource depletion are getting greatly visible, investors are becoming increasingly aware that current business models and economic activity ('business as usual') assuming unlimited natural resources are unsustainable and create systemic risk.[1] **The Bank of England's** **prudential review** of climate risks to the UK's insurance sector and the Governor of the Bank of England **Mark Carney's speech** on the threat posed by climate change to financial stability and long-term prosperity are clear signs that the investor community understands the need to take action and demonstrate leadership on climate change. In addition, it indicates that investors increasingly acknowledge the need to further align the financial system with the long-term needs of the real economy, taking into account Environmental, Social and Governance (ESG) issues as core elements.

The European Commission has recently released its **Capital Markets Union (CMU) Action Plan**[2] defining the building blocks of an effective and integrated CMU to be put in place by 2019. The CMU aims to enable European companies to access capital markets in a more integrated and effective manner in order to drive economic growth, create jobs and meet investment needs in the EU. As many other policy stakeholders (e.g. E3G, Aviva), Eurosif believes that the CMU Initiative is a great opportunity for building the foundations of a **Sustainable Capital Markets Union**. As such, we welcome **the introduction in the CMU Action Plan of Chapter 3 dedicated to "Investing for the Long Term, Infrastructure and Sustainable Investment".** In this paper we react to the CMU Action Plan, drawing on our **CMU Manifesto** and **focusing on four key pillars:**

1. **Greater transparency via mandatory ESG disclosure**
2. **A clear definition of fiduciary duty as including ESG issues**
3. **Further legislative coherence in promoting sustainable long-term investment**
4. **Enhanced long-term infrastructure investment**

1. Greater transparency via mandatory ESG disclosure

We would like to highlight the importance of transparency in promoting sustainable investment. As ESG issues can affect the long-term performance of companies, securities and investment portfolios, it is now widely recognised that climate and wider ESG risks are material to financial performance[3]. Therefore, a basic requirement for long-term sustainable investment in the CMU context, but also a key factor for financial performance of European issuers,[4] is **transparency via mandatory ESG disclosure**. It has been shown that mandatory sustainability reporting not only increases transparency but also drives improvement in ESG practices. As better ESG performance is linked to higher economic value[5], an immediate implication for policy-makers is that mandatory ESG reporting can increase value creation and

[1] Ingrid Holmes, E3G (2015). Future-Proofing the EU Capital Markets Union, Driving Sustainable Growth. E3G Briefing Paper, October 2015. See for instance the Letter sent to President Juncker and Commissioner Hill by an investor coalition, 5 February 2015 and UNEP-FI, Lenses & Clocks, 2012.
[2] The CMU Action Plan was published by the European Commission on 30 September 2015.
[3] Mark Fulton (Deutsche Bank AG), Bruce M. Kahn (Columbia University) and Camilla Sharples (Deutsche Bank AG) (2012). Sustainable Investing: Establishing Long-Term Value and Performance.
Eurosif (2013). Shareholder Stewardship: European ESG Engagement Practices.
Mercer (2009). Shedding light on SRI: Approaches, returns and impacts.
Mozaffar Khan, George Serafeim, Aaron Yoon (2015). Corporate Sustainability: First Evidence on Materiality. Harvard Business Review 2015.
[4] Mark Fulton (Deutsche Bank AG), Bruce M. Kahn (Columbia University) and Camilla Sharples (Deutsche Bank AG) (2012). Sustainable Investing: Establishing Long-Term Value and Performance.
[5] Michael Porter and Mark Kramer (2011). Creating Shared Value. Harvard Business Review 2011.

competitiveness of companies.[6] However, due to lack of (harmonised) reporting guidelines on ESG, companies experience difficulties in determining what ESG issues are of relevance for them and why. This situation creates information asymmetry on the issuer side which affects investors' ability to use this information in their decision-making processes. Moreover, it has been shown that the willingness of companies to report on ESG risks has flatlined.[7] Short-termism and excessive leverage remain significant drivers of the lack of inclusion of ESG risks in financial decision-making.[8] Due to these reasons, **as investors are increasingly looking to reduce climate and wider ESG risks in their portfolios, a long-term investment framework as well as mandatory ESG disclosure based on clear and harmonised standards are needed – both on the issuer and on the investor side.**

On the issuer side, the **Non-Financial and Diversity Disclosure Directive (2014/95/EU)** is an important first step, as it requires large companies and groups which fall under its scope to disclose policies, risks and outcomes linked to ESG matters. However, in order to address the issue of information asymmetry discussed above, we believe that it needs to be complemented by a comprehensive disclosure regime that ensures that disclosed ESG information is comparable and timely (i.e. simultaneous to financial disclosure). To this end, the Commission should be **more prescriptive and specific on Key Performance Indicators (KPI)**, both sectorial and general, as these conditions are currently not fully met by the adopted text.

On the investor side, legislation mandating investors to disclose ESG information already exists in different forms in many EU countries, such as Austria, Belgium, France, Germany, Italy, Netherlands, and UK. We believe that this type of legislation is particularly effective in advancing long-term sustainable investment as it creates incentives for investors to integrate ESG criteria and sustainability goals into investment decisions whilst fully preserving their freedom to invest in the assets they deem most relevant. As experience and research are showing, the integration of ESG criteria into investment decisions by asset managers is an incentive for issuers to improve their ESG performance, which, in turn, converts into a lower cost of capital for those issuers[9]. Given these reasons, we argue that **mandatory disclosure requirements on how investors consider climate and wider ESG issues in their investment decision-making should be built into the CMU and mainstreamed in all relevant pieces of legislation.** More specific recommendations will follow in the second part of this paper.

2. A clear definition of fiduciary duty as including ESG issues

The 'prudent person principle' in investment, known as 'fiduciary duty' in some jurisdictions, is the moral obligation of investors to act in the best interests of beneficiaries. We call for a clear definition of the concept of fiduciary duty, too often interpreted by investors and investment advisors as a duty to maximise short-term financial return. **As climate and wider ESG risks are material to business, we believe that acting in the beneficiaries' best interest means having a long-term approach to business and fully factoring in ESG issues in investment decisions.** Asset managers and institutional investors, who are naturally interested in maintaining high portfolio returns, should be able to ensure that ESG risks in their portfolios are properly measured and managed. **Therefore, we urge policy-makers to develop a clear definition of fiduciary duty as requiring a long-term approach on investment, with full consideration of ESG risks.** In this respect, interesting findings are available in the UN report 'Fiduciary Duty in the 21th Century', which shows that "integrating ESG issues into investment research and processes will enable investors to make better investment decisions and improve investment performance consistent with their fiduciary

[6] Ioannis Ioannou and George Serafeim (2011). The Consequences of Mandatory Corporate Sustainability Reporting. Harvard Business School.
[7] Corporate Knights Capital (2014). Measuring Sustainability Disclosure: Ranking the World's Stock Exchanges. Available at: http://www.corporateknights.com/wp-content/reports/2014_World_Stock_Exchange.pdf
[8] UNEP (2015). Inquiry: Design of a Sustainable Financial System. The financial system we need. Aligning the Financial System with Sustainable Development. Policy Summary.
[9] Gordon L. Clark (Oxford University), Andreas Feiner (Arabesque Asset Management), and Michael Viehs (Oxford University) (2015). From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance.

duties."[10] Another worthwhile source DG FISMA may consider is DG Environment's recently published study on resource efficiency and fiduciary duties of investors.

3. Further legislative coherence in promoting sustainable long-term investment

We urge EU policy-makers to be consistent in promoting sustainable investment. This consistent approach requires appropriate policy measures for long-term infrastructure investment, transparency via mandatory ESG disclosure, a clear and holistic definition of the concept of fiduciary duty, to be included in all relevant pieces of legislation. Thus, the new **European Framework for Simple and Transparent (STS) Securitisation**, the revised **Capital Requirements Regulation and Directive**, **Prospectus Directive**, **Shareholder Rights Directive**, **Institutions for Occupational Retirement Provision (IORPs) Directive**, as well as other CMU-related regulations, recommendations and communications should all include relevant provisions with a view to promoting transparency on ESG issues, incentivising and enabling investors to invest sustainably and responsibly.

4. Enhanced long-term infrastructure investment

We believe that promoting infrastructure investments to build a post-carbon, resource-efficient European economy is a crucial lever for promoting long-term growth, jobs and competitiveness, and as such, it should be a top priority of the CMU initiative. As both the climate challenge and the broader sustainable development challenge can be seen as inherently investment challenges,[11] it is coherent and consequential that the financial system plays its role in financing sustainable development.[12] Therefore, we applaud the Commission's acknowledgement of the significant investments needed to finance the **shift towards a low-carbon and resource-efficient European economy**. Likewise, we are pleased to see the **explicit link being made between sustainable investment and climate, energy and the UN Sustainable Development Goals.** Indeed, **investments in sustainable long-term infrastructure can and should play a key role in achieving EU decarbonisation and broader environmental and social sustainability goals.**

Proposed measures for improving the regulatory framework in order to support long-term infrastructure investments may include the creation of a cross-border fund vehicle for long-term projects via ELTIF Regulation, revising the risk exposure following Solvency II requirements and reviewing banks' capital requirements for long term and infrastructure investments in the Capital Requirements Regulation (CRR). **Eurosif is supportive of such measures as long as: i) they are aimed at promoting sustainable investments in low-carbon and resource-efficient infrastructures, ii) they are properly considering climate and wider ESG risks, and iii) they do not threaten financial stability by feeding valuation bubbles through tweaked capital requirements.** In particular, we believe that these measures should incentivise investments replacing old, emission and resource intensive infrastructures and technologies, and that **all promoted investments should be based on sound analysis, disclosure and management of ESG risks**.

As regards **green bonds**, we believe that they are a promising tool for channeling long-term capital towards green infrastructure projects. Thus, we are pleased to see the Commission's recognition and pledge to support the development of the green bond market. However, we highlight that **sustainable investment factoring in ESG issues should be promoted across all asset classes and not only in relation to green bonds.**

[10] UN Global Compact, UNEP FI, PRI, UNEP Inquiry (2015). Fiduciary Duty in the 21th Century, page 10. Available at: http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf
[11] Mark Halle (UNEP Inquiry) speaking at the Novethic Annual Event 2015 on the UNEP Inquiry into a sustainable financial system.
[12] UNEP (2015). Inquiry: Design of a Sustainable Financial System. The financial system we need. Aligning the Financial System with Sustainable Development. Policy Summary.

Policy recommendations

Legislative development / piece of legislation	Eurosif recommendations
Commission proposal for simple, transparent and standardised (STS) securitisations 2015/0226 (COD)	**First**, while recognising the financial stability risks linked to securitisation, Eurosif **supports reviving securitisation in a sustainable way following the principles of simplicity, standardisation and transparency**. In order to avoid financial stability risks, only securitisations that are **transparent, clearly structured, and prudently underwritten** should be eligible under the new regulation, and they should benefit from appropriately calibrated 'prudential' treatment.[13] **Second**, we believe that if properly structured, securitisation can be an effective way to lower the cost of capital and **scale up investments in low-carbon and green infrastructure projects** by allowing smaller scale assets such as renewable and energy efficiency assets to be aggregated in order to access the bond markets. **Eurosif therefore recommends promoting and removing barriers to "green securitisation", as it was discussed in June 2015 in the Green Securitisation Roundtable.** Outputs from this initiative will feed into a policy brief jointly prepared by the Climate Bonds Initiative and the Grantham Institute for Climate Change, to be published soon.[14] **Green securitisation markets** are already developing in other parts of the world. **Third**, it has been shown that enhanced disclosure of information and the ability of investors to analyse and understand risks more in-depth are both key measures needed to restore investor confidence in securitisation markets.[15] In order to provide investors with a holistic view on investment risks, we believe that it is key to **include mandatory ESG disclosure requirements in the new framework for STS securitisations.** For instance, the recent **French Law for the Energy Transition and Green Growth n°2015-992** puts in place an **obligation for investment funds and institutional investors to report on ESG issues, exposure to climate-related risks, greenhouse gas (GHG) emissions and contribution to climate and energy policy goals.** According to **Article 173** of this law, these investment entities will need to include in their annual report information on how they take into account social, environmental and good governance (ESG) criteria in their investment policy, as well as the measures they put in place for contributing to the energy and environmental transition. **This type of disclosure requirements in the context of the new securitisation framework would be particularly useful.**
Review of the Prospectus Directive (2003/71/EC)	The aim of these **revisions to the Prospectus Directive** through delegated acts is to make it easier for companies (notably SMEs) to draw up a prospectus and access capital markets, while ensuring effective investor protection. To this end, the Commission will update when a prospectus is needed, and streamline the information required and the approval process.

[13] EFAMA's submission to the European Commission's Green Paper "Building a Capital Markets Union" (2015). Available at: http://www.efama.org/Publications/Public/EFAMA%20response%20to%20CMU%20Green%20Paper.pdf

[14] Climate Bonds Initiative, London School of Economics, Centre for Climate Change Economics and Policy, Grantham Institute for Climate Change, Economic and Social Research Council (2015). Green Securitisation Roundtable: A public sector agenda for green securitisation market development in Europe. 8 June 2015, Discussion primer. Available at: https://www.climatebonds.net/files/files/Discussion%20primer%20Green%20Securitization%20Roundtable%208%20June.pdf

[15] PwC (2012). Securitisation – new due diligence challenges. Available at : https://www.pwc.com/gx/en/structured-finance/pdf/pwc-securitisation-due-diligence-pdf.pdf

	We believe that this represents a good opportunity for **including ESG disclosure requirements in prospectuses, which would add value for investors due to the reasons explained above.** These would also **work in the favour of companies (including SMEs) with superior ESG performance, which are increasingly preferred by responsible investors**. However, ESG disclosure requirements should be proportional with the size of the company, and should not disproportionately overburden SMEs. As a principle, links to already available ESG information (e.g. from annual reports) should be acceptable.
Revision of the Shareholder Rights Directive (SRD) (2007/36/EC)	**We strongly advocate for a revised SRD that encourages institutional investors and asset managers to adopt proactive and long-term oriented share ownership policies and practices that properly factor in ESG issues.** In the context of the revision of SRD, we recommend the introduction of **detailed ESG transparency requirements for institutional investors via a mandatory Statement of Investment Principles ('SIP'),** in which institutional investors would state, on a comply-or-explain basis, the extent to which ESG considerations are taken into account in the selection, retention and realisation of investments, and how they implement such SRI policies. Furthermore, we strongly recommend that **key advisors in the investment chain also disclose how sustainability and ESG factors are taken into account in their recommendations**. For instance, investment consultants, who are gateways to significant amounts of institutional money, should be encouraged to develop a Code of Conduct for their industry, requiring them to incorporate ESG issues into their analysis and recommendations. Many consultants still do not raise stewardship issues with their clients. Brokers, proxy advisors and credit rating agencies should also be encouraged to incorporate these considerations in their work.
Revision of Institutions for Occupational Retirement Provision (IORPs) Directive (2003/41/EC)	**The European Commission's proposed text for revising the IORPs Directive included a requirement for all IORPs to consider "new or emerging risks relating to climate change, resource use and the environment."** While reviewing the Commission's proposal, regrettably both the European Parliament and the Council deleted this requirement from the initial drafts. Eurosif believes that this could be a missed opportunity for promoting long-term sustainable investment to the benefit of pensioners, the economy and the environment. As explained, ESG issues are material to business and investment returns, and as such, they should be part of the fiduciary duty of pension fund trustees, and currently they are not. **A prominent example of IORP not taking into account ESG risks is the Retirement Savings Vehicle for European Research Institutions (RESAVER).** As part of a coalition of stakeholders led by ShareAction, Eurosif co-signed a **joint letter** sent to all the Members of the European Parliament ECON Committee ahead of their vote initially scheduled for 1 December 2015. **We are calling not just for this clause to be put back into the text, but for the IORPs revision to go further and mandate all IORPs to consider ESG risks and also require transparency around investment policies and practices, in line with investment best practice.** Furthermore, we urge MEPs to use the opportunity presented by the revision of this Directive to **clarify the law as regards fiduciary duty of pension fund trustees.** This would help to promote transparency, proper management of ESG risks and long-term sustainable investment in the pensions sector, and to ensure consistency with EU legislation increasingly prompting investors and companies to factor in ESG risks and issues in their decision-making processes.

About Eurosif

Eurosif is the leading pan-European sustainable and responsible investment (SRI) membership organisation whose mission is to promote sustainability through European financial markets. Eurosif works as a partnership of Europe-based national Sustainable Investment Forums (SIFs) with the direct support of their network which spans across over 400 Europe-based organisations drawn from the sustainable investment industry value chain. These organisations include institutional investors, asset managers, financial services, index providers and ESG research and analysis firms totalling over €8 trillion in assets. Eurosif is also a founding member of the Global Sustainable Investment Alliance (GSIA), the alliance of the largest SIFs around the world. The main activities of Eurosif are advocacy, research and creating platforms for nurturing sustainable investing best practices.

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