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Implementing the European Commission's Sustainable Finance Action Plan: Legislative proposals

Opinion by the EIOPA Occupational Pensions Stakeholder Group

Introduction

1. On 24 May the European Commission published four legislative proposals to follow-up on its 'Action Plan: Financing Sustainable Growth'. The Action Plan, published in March 2018, was based on the recommendations of the High-Level Expert Group on Sustainable Finance of January 2018.
2. The package of proposals consists of the following measures:
    a. A legal basis for the classification of environmentally sustainable activities ('the taxonomy').
    b. A proposal on disclosures for institutional investors. This proposal also would empower the Commission to adopt delegated acts under IORP2, in order to specify and harmonise investor duties through delegated acts for all types of institutional investors at a later stage.
    c. An amendment to the Benchmarks Regulation to improve the transparency of low carbon benchmarks and positive carbon impact benchmarks.
    d. Proposals to include ESG considerations in investment advice to investors by amending Delegated Acts under MiFID2 and IDD.
3. The OPSG believes that the debate of ESG-investment should not be monopolised by financial professionals. Environmental, social as well as governance issues should be subject to a broad discussion by various stakeholders and policymakers. Nevertheless the OPSG can provide valuable technical input for this discussion.

The Taxonomy

4. The HLEG report found that the lack of common definitions on what constitutes 'sustainable', is harming investor confidence in environmental, social and governance (ESG) investments. Both for retail and institutional investors it can be unclear at times whether the composition and performance of their 'sustainable' investments indeed match their sustainability preferences. Moreover, there is a lack of comparability between investments and products.
5. To mitigate these challenges the High-Level Expert Group proposed to establish a science-based objective classification system to assess the sustainability of economic activities. The European Commission has now published a draft regulation to serve as the basis for the taxonomy for environmental sustainability.
6. The OPSG agrees on the importance of adopting a taxonomy as an *enabler* for integrating ESG factors in investment decisions. If designed properly, it can help pension funds and other investors to understand and measure the sustainability risks in their portfolios. It can also serve as a basis for discussions with investment managers about ESG integration when agreeing mandates or selecting investment funds.
7. According to OPSG it is also a useful communication tool for disclosures towards members and beneficiaries.
8. It should be recognised that a taxonomy that offers a binary assessment of whether activities are e.g. green, or otherwise sustainable, would not capture all responsible investment approaches. For example, asset owners might pursue investment with the objective of climate change mitigation through a best-in-class approach in polluting industries. Others put more emphasis on changing the behaviour of their portfolio companies (voice instead of exit) through engagement (stewardship). In this case ESG also concerns the way the IORP behaves as a shareholder which is currently out of scope of the proposed legislation. It may also be that the ESG-funds may have no ownership in the companies the members and beneficiaries would want to change the most with their ESG-investments.. It is therefore important that

having a high 'score' of ESG assets under the taxonomy does not become synonymous with responsible investment or ESG investing. The taxonomy is a useful tool, but not a silver bullet.

9. The OPSG believes the EU should be very cautious in adopting the taxonomy as a prudential tool. Prudential frameworks should remain risk-based. ESG investments will often be long-term and there are concerns that some of the existing prudential rules need improving to better reflect the true risks of such long-term investments. However, this is a question of getting the risk measurement right and not directly linked to ESG investments. While some argue that ESG risks are sufficiently material to include them into prudential frameworks, there is a risk that politicians wish to achieve political objectives by tweaking risk weights or capital charges. As investors in the banking and insurance sectors, pension funds want to see strong evidence of 'green' support or 'brown' penalising factors contributing to financial stability, before such measures should be adopted. Similarly, policy-makers should be very careful before making the use of the taxonomy mandatory as a risk-management tool. However carefully designed, it is not inconceivable that the taxonomy will overstate or understate some types of ESG risks. A too strong and harmonised dependency on the taxonomy could then lead to green bubbles.

10. The OPSG understands the political imperative of focusing on climate change mitigation and adaption as the implementation of the Paris Agreements requires swift policy action. However, the OPSG points out that the "E" is more than climate, as it also entails pollution, depletion of resources, biodiversity, and other environmental factors. Moving towards sustainable development requires to follow a holistic approach integrating the environmental, social and governance factors. The OPSG emphasises the need to develop the "S" and "G" pillars of the taxonomy as quickly as possible, in particular because currently the integration of governance factors is arguably the most advanced and pension funds as social institutions are naturally close to socially sustainable investments.
11. A comprehensive approach to the development of the taxonomy, incorporating the E, S and G factors, is key. The OPSG further believes that the application of regulatory requirements that are linked to or based on the taxonomy should be voluntary until the full taxonomy is finalised. This would limit investors' uncertainty over application of an incomplete taxonomy, would avoid unnecessary costs and also minimise potential legal risks.
12. The OPSG also notes that pension funds and other financial market participants need robust and extensive data from public companies in which they invest in order to properly assess the ESG risks and opportunities involved. The annual report of public companies can in this respect be an important source of information. The OPSG would welcome the adoption of standards for company disclosure of ESG risks in order to facilitate the taxonomy process and to facilitate ESG auditing. Besides the fact that mandatory disclosure of information about ESG risk in financial statements helps pension funds to assess the ESG risk at the same time it will reduce the cost of "due diligence" for pension funds which they would have if such information was not disclosed.
13. The OPSG considers that as part of their evaluation of the risk connected to investment in particular financial instruments, rating agencies should disclose to what extent and how they integrate E, S and G elements in their rating and overall risk evaluation of the rated company or the issued paper.

14. Information on risks related to the issuing company and/or the project to be financed is given in information memorandums and prospectuses issued by the house(s) arranging the financing deal. This information has to be given according to the rules regulating the relevant

capital markets and the stock exchanges listing the paper. Information memorandums or prospectuses should as a support to ESG financing always contain sufficient information to evaluate the ESG aspects and risk issues of the particular offering, thus also securing a correct taxonomy of the issued paper and the issuing company.

Investor Duties

15. While it is generally considered that a modern understanding of the fiduciary duty should not constitute a barrier for integrating ESG risks as financially material factors in investment decisions[1], the HLEG recommended the EU should clarify and harmonise so-called investor duties across the relevant pieces of legislation. The HLEG noted that "investors should incorporate sustainability factors consistent with the broad interests, investment horizons and sustainability preferences of their clients and beneficiaries. It should also be clarified that stewardship of investments is a fundamental element of fulfilling these duties."
16. While it is clear that investment according to ESG-factors are abstractly allowed it is often unclear under which circumstances they are concretely allowed (e.g. whether they need the consent of the members and beneficiaries or at least from the employer etc). There are some cases where IORPs were found in breach of law because they favoured ESG-investment instead of maximising performance.[2] It is not clear to what extent the prudent person principle allows IORPs to invest according to ESG-factors even if this could impair returns.
17. The OPSG already set out[3] the challenges of ascertaining the sustainability preferences of pension schemes' beneficiaries and acting upon those, in particularly in a defined-benefit context. This problem is exacerbated by the fact that research is inconclusive on the trade-off between sustainability and returns. The OPSG notes that the current proposal does not (yet) include the mandatory consultation of members and beneficiaries. Academic research reveals that such consultation can hardly lead to concrete and objective results, because it is very complicated to gauge preferences in a quantitative manner.
18. In order to implement the HLEG's recommendation on investor duties, the European Commission did not opt for the suggested tool of an Omnibus Directive, but rather intends to adopt Delegated Acts. Most of the relevant directives and regulations already provide the power of delegation in this area, apart from the IORP2 Directive. Therefore, the Commission has proposed to be empowered to adopt Delegated Acts on the ESG provisions in under the 'prudent person' rule (Article 19), ensuring that "environmental, social and governance factors [are included] in internal investment decisions and risk management processes". These Delegated Acts shall be take into account the size and complexity of the IORP, mirroring the current opt-out clause under recital 58. It could be possible this will mean that the Commission will set quantitative thresholds for mandatory ESG integration.
19. While it may make sense to make the integration of ESG factors mandatory for IORPs, the OPSG does not support the legal tool of Delegated Acts. During the negotiations of the IORP2 Directive, risk management was specifically and deliberately left outside the competence of EIOPA and the European Commission to regulate it with delegated acts. The amendment would therefore fundamentally change the IORP2 as adopted by the co-legislators. The OPSG

[1] See for example UNEP FI (2005) 'A legal framework for the integration of environmental, social and governance issues into institutional investment'

[2] *Horvathova/Feldthusen/Ulfbeck,* Occupational Pensions (IORPs) & Sustainability: What does the Prudent Person Principle say?, The Nordic Journal of Commercial Law 2017/1, 29.

[3] EIOPA-OPSG-18-13 Response by the EIOPA Occupational Pensions Stakeholder Group to the European Commission's Action Plan: Financing Sustainable Growth.

believes national supervisors continue to be best equipped to oversee how pension funds manage ESG risks, in order to take account of local governance structures and sustainability preferences. As insurers, asset managers and pension funds have very different role, a harmonised approach does not need to be an objective by itself. Moreover, from a 'better regulation' perspective, it is questionable to amend the Directive's ESG provisions while they are still under implementation by Member States.

20. The proposal also sets out new disclosure requirements for institutional investors, including pension funds, insurers, insurance intermediaries and asset managers. They will be required to disclose both pre-contractually and periodically on the procedures and conditions applied for integrating sustainability risks, the projected impact on returns and how remuneration policies are consistent with the integration of sustainability risks. There are higher information requirements for financial products that are marketed as 'sustainable', such as data sources, screening methods and indicators to measure the overall sustainable impact.
21. The OPSG welcomes the disclosure requirements as useful tools for asset owners and beneficiaries to understand how sustainable their investments or pensions are. They should help to address 'greenwashing', or in some cases the potentially unwarranted perception thereof. At the same time, the OPSG considers that it would be inefficient and confusing for investors if the disclosures proposals were implemented before the taxonomy is finalized. As the main goal of the disclosure proposals is to incorporate ESG considerations in the choice of savings products by retail investors, it is essential that the information they receive needs to go beyond climate targets to "E", S" and "G" factors.