Questionnaire by the High Level Expert Group on sustainable finance interim report

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Question 1. From your constituency point of view, what is the most important issue that needs to be addressed to move towards sustainable finance? (sustainable finance being understood as improving the contribution of finance to long-term sustainable and inclusive growth, as well as strengthening financial stability by considering material environmental, social and governance factors)

Frank Bold Society is a purpose driven law firm that works to solve environmental and social problems. It co-organised the Purpose of the Corporation project: a global roundtable series that brought together over 260 leaders in business management, investment, academia and civil society to identify desired outcomes and principles of corporate governance fit for the challenges of the 21st century.

It generated several recommendations relevant for sustainable finance:

1. Any solution to short-termism must, in addition to expanding and broadening investors' horizons, recognise that listed companies need to be protected from the pressure to maximise short-term shareholder value.
2. It would be desirable to clarify European companies' directors' duties as well as fiduciary duties of institutional investors in regard to the focus on long-term sustainable value creation, ESG matters, and systemic risks.
3. Institutional investors - when they engage with boards of investee corporations – need to reflect end-beneficiaries' long-term interests and the time horizons of their investment strategies.
4. Reporting obligations should extend to how fiduciary duties have been discharged.
5. Reporting and accounting metrics for ESG issues need to be further developed and harmonized and integrated with financial accounting.
6. Incentive structures, both in companies and in the financial industry, need to reflect the above considerations.

Develop a classification system for sustainable assets and financial products

Question 2. What do you think such an EU taxonomy for sustainable assets and financial products should include?

The taxonomy should be based on a common definition of sustainability that integrates baseline criteria for all social and environmental matters outlined in the planetary boundaries and doughnut economics models. It should be focused upon excluding industries and individual businesses with negative impacts on sustainability, and including industries and individual businesses with positive impacts on sustainability. It would be sensible to use pre-existing taxonomies as a starting point, such as that of the Climate Bonds Initiative, and to commit resources to analysis of the sectors and industries in which more work is needed, as well as any that are missing. A European Credit Rating Agency would be ideally placed to consult with scientific and civil society organisations with a view to developing the taxonomy in a transparent and comprehensive manner.

We have no opinion as to what types of products or assets should be included. We recommend, however, to keep the system as simple as possible.

Establish a European standard and label for green bonds and other sustainable assets

Question 3. What considerations should the EU keep in mind when establishing a European standard and label for green bonds and other sustainable assets? How can the EU ensure high-quality standards and labels that avoid misuse/green-washing?

Green bonds should be available only for the projects that are realised within a clear regulatory framework supported

[1] The SMART project is funded by EU Horizon 2020 grant number 693642.

by reliable control mechanisms and if the connection between the green bonds and projects that are financed is traceable.

Second party review of, and advice in relation to, financing decisions by issuers will enhance credibility. CICERO, for example, currently does this on a largely private basis. Making second party reviews public would further enhance credibility. In addition, a new public pan-EU credit rating agency could provide third party certification. Use of a public credit rating agency to perform this function would avoid duplication of effort, allow for the development of expertise related to sustainability and avoid the difficult issues of incentives that affect private CRAs.

Green bonds and other sustainable assets could be given priority both for repo with the central bank, and in EU regulatory instruments such as the CRD and CRR that require financial institutions to hold assets with certain credit ratings, or to reduce capital requirements against certain sustainable assets. Similarly, efforts could be made to amend the new Securitisation Regulation to incentivise increased funding of sustainable projects. Creating a link between the new standard and label, and the regulatory treatment of those assets would improve their marketability and so incentivise their creation, purchase and retention by the various institutions involved.

Create “Sustainable Infrastructure Europe” to channel finance into sustainable projects

Question 4. What key services do you think an entity like “Sustainable Infrastructure Europe” should provide, more specifically in terms of advisory services and connecting public authorities with private investors?

Infrastructure, by definition, is meant to connect various parts of the system to ensure their effective functioning. Therefore, one of the key functions of “Sustainable Infrastructure Europe” should be to advise investors on the importance and relevancy of infrastructure projects in the context of coordinated EU plans.

“Sustainable Infrastructure Europe” could also facilitate local, community-owned infrastructure and renewable energy projects. Renewable energy provides an opportunity for decentralisation and localisation of energy production, which in turn lowers the need for long-distance energy transfer, thus changes and decreases requirements for the infrastructure, and mitigates energy losses.

It is important that this initiative does not incentivise privatisation of infrastructure. Privatisation in this sector is a complicated question with political implications, the answer to which depends on circumstances. Support for privatisation, whether intended or not, may have unintended consequences especially in those EU Member States that wrestle with corruption.

The report also touches upon areas for further analysis. The following questions focus on a selection of these, which the group would appreciate your feedback on:

Mismatched time horizons and short-termism versus long-term orientation

Question 5. It is frequently stated that the inherent short-termism in finance, especially financial markets, represents a distraction from, or even obstacle to, a long-term orientation in economic decision-making, including investments that are essential for sustainability. Do you agree with this statement?

Yes / No / Don’t know

Question 5.1. If you agree with this statement, which sectors of the economy and financial system are particularly affected by the ’mismatch of time horizons’? What are possible measures to resolve or attenuate this conflict?

All listed companies are affected regardless of sector, because capital markets pressure them to spend their earnings for the immediate benefit of shareholders, e.g. in the form of dividends or stock buybacks, rather than retain and reinvest them. This is particularly problematic in manufacturing sectors that require significant investments in technologies to achieve sustainability and in sectors that require long-term R&D investment, such as the biotech/pharmaceutical industries. Such pressure also affects consumer goods, agricultural products, and retail sectors where it contributes to the race to the bottom in wages in the EU and to the exploitative and precarious conditions in global supply chains.

A specific effect in highly concentrated industries is connected to acquisitions and takeovers. Directors rarely have any opportunity to defend against bids that threaten corporate sustainability strategies, with the outcome entirely in the hands of shareholders, who rarely reject a bid that promises them a premium over the current market price of their shares.

Corporate governance provides several options to manage this conflict:

- clarify directors' and institutional investors duties
- link incentive structures to long-term strategic goals
- reform corporate reporting obligations and accounting framework
- allow protection of corporate purpose in governance documents and arrangements
- allow defensive structures which offer protection against takeovers that threaten corporate strategy

Governance of the investment and analyst community

Question 6. What key levers do you think the EU could use to best align the investment and analyst community with long-term sustainability considerations in the real economy?

Fiduciary duties of institutional investors should be clarified with respect to sustainability. These duties should require investors to assess and address ESG matters and systemic risks in the investment and engagement strategy and decisions, taking into account end beneficiaries' interests, and align the strategy of agents down the investment chain.

Investors should disclose their investment and engagement strategy with respect to ESG risks and integration of ESG and financial analysis, how it is implemented in practice (investment decisions, voting, and engagement), and how it is reflected in internal incentive schemes.

To achieve the use of appropriate metrics and disclosure by investee companies, new accounting and valuation models for non-financial capital need to be developed, while
policy-makers should specify reporting requirements with respect to risk evaluation, KPIs, and integration with financial reporting. Investors may be required to consult on ESG issues with end beneficiaries, although more work is required to determine how this might be operationalised.

Rating agencies, benchmarks, index funds and other forms of passive investment, and proxy advisors create constraints and uniformity of behaviour, which may provide systemic risk in themselves. Therefore, the abovementioned changes to fiduciary duties and disclosure requirements must be supported by analogous changes to fiduciary duties and reporting requirements imposed on these actors.

A strong pipeline of sustainable projects for investment

Question 7. How can the EU best create a strong and visible pipeline of sustainable investment projects ready for investment at scale?

No opinion. However, with regard to availability of capital, the EU should:

1. Address one of the root causes of lack of finance for such projects in listed companies, which is that capital markets often extract from, rather than contribute capital to companies. The regulatory strategy for corporate governance currently focuses on transparency and relies predominantly on shareholder pressure, which reinforces the focus on maximising shareholder value and short-termism. It should instead aim to give greater space to companies to retain and reinvest the profits they are making.

2. Deliver on the stated priority of the 2015 EU Capital Markets Union Action Plan to ensure "an appropriate regulatory environment for long term and sustainable investment and financing of Europe's infrastructure", and press on with measures previously outlined by the Commission, such as:
   - Ongoing support for the European Fund for Strategic Investments (€240 billion for infrastructure financing)
   - The review of the treatment of infrastructure investment under bank capital requirements (under CRR)
   - Promoting European Long Term Investment Funds (ELTIFs) as alternative investment vehicles for infrastructure projects and encouraging standardised pan-European tax treatment of such vehicles

Integrating sustainability and long-term perspectives into credit ratings

Question 8. What are some of the most effective ways to encourage credit rating agencies to take into consideration ESG factors and/or long-term risk factors?

Please choose 1 option from the list below.

- **Create a European credit rating agency designed to track long-term sustainability risks**
- Require all credit rating agencies to disclose whether and how they consider TCFD-related information in their credit ratings
- Require all credit rating agencies to include ESG factors as part of their rating
- All of the above
- Other

There is evidence in the U.S. that, before the crisis, CRAs prioritised market share over reputation, and that this was driven to some extent by remuneration practices within CRAs which rewarded managers with stock-based compensation. In other words, the CRAs suffer from the same short-termist orientation as the banks and companies whose financial instruments they rate. The EU's Regulation on CRAs did not address this issue. CRAs remain highly responsive to their clients' demands, and so will not move to produce ratings based on sustainability criteria unless their clients demand them. Hence an intervention in the market is desirable.

The argument for creating a European CRA is strong: it would not be affected by short-termism of its private sector counterparts, and would be able to include TCFD and ESG information in its ratings directly. In any event, we recommend creating a European CRA at least to provide third party certification of green bonds.

An alternative would be to create a European CRA, with investments certified by it given priority by the ECB and other central banks for repo, and given greater weighting under the CRD. By privileging the ratings of the public agency, but making provision for private agency ratings to receive similar treatment if their ratings adequately reflect sustainability criteria (something which would be determined by e.g. ESMA), the private agencies would begin to incorporate sustainability considerations into their ratings.

Role of banks

Question 9. What would be the best way to involve banks more strongly on sustainability, particularly through long-term lending and project finance?

A crude but effective option would be to require banks to direct a certain percentage of their lending to long-term and sustainable projects.

Securities based on bank lending which satisfies sustainability criteria could be given priority for repo, perhaps at preferential rates, and the underlying loans could be given a lower risk rating for regulatory purposes relative to loans which do not conform to sustainability criteria. It should be properly considered, however, that this may increase risk for financial institutions which may be reflected in higher interest rates.

In any case, it is important to focus on the conditions under which such projects are realised. In practice this means setting regulatory, tax, and public subsidy policies to favour or provide guarantees to sustainable projects, especially to those with return on investment projected in the long-term, and to disadvantage unsustainable projects.

Role of insurers

Question 10. What would be the best way to involve insurers more strongly on sustainability, particularly through long-term investment?

See answers to questions 1, 6, and 12. In particular, insurers should be required to develop a strategy that takes account of ESG matters and systemic risks, reflecting end-beneficiaries' long term interest and time horizons for the investment strategy. This strategy should be reflected in internal incentive schemes and reported on.

Social dimensions

Question 11. What do you think should be the priority when mobilising private capital for social dimensions of sustainable development?

No opinion. However, in addition to any strategy to mobilise capital for socially responsible projects, an equal attention should paid to minimise adverse social impacts supported or incentivised by the financial system.

In particular, EU policies should moderate the focus of current corporate governance models on maximising shareholder value which is one of the main drivers of growing inequality in society and across national, European and world regions.

Furthermore, investors and lenders may be required to carry out due diligence in line with the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises in order to identify and address major social (and environmental) impacts associated with the investments, such as human rights and labour violations, environmental degradation, land grabbing, etc.

Other

Question 12. Do you have any comments on the policy recommendations or policy areas mentioned in the Interim Report but not mentioned in this survey?

We support the call of the HLEG to open a policy discussion on corporate governance as it plays a key role in facilitating short-termism both in financial industry and in listed companies.

It would be desirable to clarify that directors' duties are owed to the company rather than the shareholders (correcting a common misconception) and confirm that their core is to ensure the company's longevity and success; that directors should not focus on short-term increases in the share price at the expense of long-term sustainable value-creation; and that they are under an obligation to evaluate ESG risks to, and opportunities for, their business. This clarification would support directors as well as sustainable investors in their engagement with boards.

EU policy and corporate governance codes can support managerial stewardship by linking incentive structures to the company's long-term goals, ensuring that boards are equipped with necessary expertise, encouraging stakeholder engagement through representation or consultation, and increasing the influence of patient capital.

Stewardship codes can provide further guidance. However, their effect is limited due to the short-term focus of the capital market environment and the difficulties facing institutional investors who seek to engage with a large number of corporations in their portfolio.

Corporate governance also depends on a functional model for integrated reporting which must be supported by appropriate changes to accounting standards.

Question 13. In your view, is there any other area that the expert group should cover in their work?

In our opinion, the expert group should set out key elements for the defition of sustainability that will be indispensable for an effective implementation of its recommendations. Such definition should build upon the concept of nine planetary boundaries that was developed by Johan Rockström from the Stockholm Resilience Centre and Will Steffen from the Australian National University and their colleagues; and upon the Doughnut Economics model proposed by Kate Raworth that combines those planetary boundaries with twelve dimensions of the social foundation derived from internationally agreed minimum social standards, as indentified in the Sustainable Development Goals in 2015.