Long Term Investment and Reindustrialisation Intergroup

#Invest4Future

MINUTES OF THE DINNER-DEBATE

ESG CRITERIA AND THE CAPITAL MARKETS UNION

On November 9, the Long-term investment and reindustrialisation Intergroup of the European Parliament held a dinner debate on ESG criteria in the context of the Capital Markets Union (CMU) in the presence of Members of the European Parliament (MEPs), officials from the European Commission, and representatives of the industrial and the financial sector and of the civil society.

I. List of the speakers

- Sirpa PIETIKAÏNEN, MEP, Member of the Long-term Investment Intergroup
- Olivier GUERSENT, Director-General for Financial Stability, Financial Services and Capital Markets Union, European Commission
- Will OULTON, Global Head, Responsible Investment at First State Investments (FSI) & President of the European Sustainable Investment Forum (EUROSIF)
- Anne-Catherine HUSSON-TRAORE, Director General, Novethic
- Rita GEYERMANN, First Vice President, Head of Asset Management at KfW
- Pervenche BERÈS, MEP, Member of the Long-term Investment Intergroup

II. Opening remarks and keynote speech

MEP Sirpa Pietikaïnen welcomed the participants and introduced the speakers. She then addressed the general issue of short-termism and the responsibility of policymakers to change the mindset towards a long-term perspective. To that end, she insisted on the importance of the credibility of regulation: legal certainty and long-term predictability are needed to channel investments towards a sustainable economy. Subsidies to fossil fuels must end and the EU budget must sustain its support to climate action. To channel private financing, environmental risks consideration by rating agencies should be generalized and policy makers should define sustainability investment criteria to help investors as the challenge is not in the access to data but in the lack of comparability over time and geographical areas. Sirpa Pietikaïnen also called for buffer requirements which would penalize "brown" investments and favor green investments. Innovations in financing are also key to meet the challenge ahead: what about crowdfunding solutions for sustainable infrastructures? Also, as buildings represent 40 percent of the EU's final energy use, a special focus on the financing of energy efficiency is needed, she said. She concluded her remarks by insisting on the political significance of the challenge of climate change for our societies and the legitimacy of the European Union.

Olivier Guersent, Director-General for Financial Stability, Financial Services and Capital Markets Union at the European Commission, then took the floor to deliver his keynote speech. He claimed it was an important time for Sustainable and Responsible Investments (SRI) with the topic having gained momentum over the past 5 years. A trend for which the Financial Stability Board (FSB) has played an important part. He welcomed the fact that beyond the traditional long-term investors such as the NPBIs (the French Caisse des Depots Group or the Italian *Cassa depositi e prestiti*), other high impact investors have started integrating ESG criteria in their investment policy such as the asset manager Blackrock. It is an interesting case as they consider SRI not only as a constraint but as an opportunity.

On its part, the European Commission has been adaptive. A major initiative was the Green Paper « on the Long Term Financing of the European Economy » launched in 2013 by Commissioner for Internal Market and Services, Michel Barnier. This Green Paper constitutes the foundation on which the Capital Markets Union was originally designed and is being implemented. Sustainable finance, as correlated with long-term investment, is indeed an important feature of the Capital Markets Union, as illustrated by the recent public consultation on long term and sustainable investments whose answers have been published. Olivier Guersent delivered its main conclusions.

- Overall the first conclusions are an increase in ESG awareness among investors and a genuine interest in the topic as 91 organizations responded to the consultation. But the picture is very patchy as ESG factors are still considered as risks rather than opportunities. There is still a focus on short term results which is a bad paradigm. Recent initiatives from the European Commission seek to change this mindset.

- The consideration of ESG factors in the remuneration policy at board level could be an idea as a greater board ownership of ESG reporting is important, Mr Guersent said.

- Some respondents to the public consultation considered EU regulation as being pro short term due to notions such as « mark to market » and the way prudential requirements are designed.

- A common issue throughout the answers was the remaining difficulty with ESG data collecting in the process of selecting asset managers. On a more political level, Mr Guersent said that the relevance of ESG for evaluating performance of a company should be more recognized. He also urged institutional investors to change their policy and make explicit ESG requirements when selecting their asset managers but acknowledged the issue of fiduciary duty.

Olivier Guersent considered the extension of the scope of the EU financial markets legislation within the European Union Emissions Trading Schemes (EU ETS) through the MIFID II approach as a good step but suggested envisaging complementary action with the inclusion of the issue of carbon into post-trade legislation also. He mentioned the call for application for a High level expert group on sustainable finance whose composition should be balanced and high leveled. The Commission is in the process of selecting its Chairman and favors a VIP with a political dimension. Social and governance aspects will be included in the mandate even though the focus will be on green finance. Articulating their work with other international expert groups, they will be tasked to deliver a coherent package of policy measures. Olivier Guersent then reminded the audience of the upcoming transposition of the Directive 2014/95/EU on disclosure of non-financial and diversity information by certain large undertakings and groups, scheduled for December 6, 2016. A remaining challenge indeed for investors is the lack of reliable and comparable ESG data.

He then addressed the green bond market and considered it another way to steer investments towards environmentally and socially superior projects. The Directorate General for Climate Action should soon release a study on the subject. Finally the social entrepreneurship fund is being reformed.

Beyond these specific items, the European Commission is reflecting around the purpose of financial regulation: the role of modern regulation, such as prudential regulation, is to create a conducive environment for socially useful behavior (for instance polluting trucks to be more expensive than less polluting trucks). In this context, Olivier Guersent addressed an important current topic: the relevance of the Green supporting factor (lower capital requirements for financing and investing in green assets). O.Guersent demonstrated personal opposition to this idea as to any risk calibration based on a political principle, rather than objective and informed demonstration of the low-risk nature of the assets. He suggested that should rather be designed higher prudential requirements to penalize investments detrimental for the environment so as to internalize the cost of negative externalities.

Another controversial topic was the work of the IFRS foundation: the European Commission contributes up to a third of the budget of the IFRS foundation and gave away in 2004 any possibility to carve out their standard. O.Guersent said that a written request by the Commission to review the impact of their policy towards long-term investment and they refused. Mr. Guersent personal view to thatthe right to carve out IFRS standards before transposition into EU law should be retrieved. One universal standard is ideal but Europe can't let its position be systematically dismissed. Olivier Guersent concluded his intervention by commending the ongoing reforms in the European Financial Reporting Advisory Group (EFRAG).

III. Long Term, Sustainable & Responsible Investment - an essential component of Europe's Capital Markets

Will Oulton, Responsible Investment at First State Investments (FSI) & President of the European Sustainable Investment Forum (EUROSIF) argued that the matter was the lack of trust and that it was urgent to change behaviours and to find a consensus on the meaning of a long-term perspective. The issue with the notion of fiduciary duty can be overcome in the context of climate change: how to protect long-term returns for the interest of my customers without considering environmental risks?

But there is still a lack of SRI awareness. He recalled a recent meeting with influential investors with no prejudices against SRI but who claimed that they lacked the instruments to evaluate financial performance associated with SRI. SRI is a very recent concept with the Principles for Responsible Investment (PRI) signed only a decade ago. Until now there is no SRI component in the renowned Chartered Financial Analyst (CFA) training program but Mr Oulton was told there was discussion to remedy this lack. Regarding retail investors, he placed hope in the millennials and their different expectations of investments as drivers for change.

Will Oulton also cited an interesting private initiative, the "People's Trust", launched by former British trade body Investment Association Executive Director Daniel Godfrey. The "People's Trust" is a long-term investment fund 100% owned by its customers and whose governance has been designed to ensure alignment of interest between the management and its customers. An initiative with a political perspective, the Fund is being raised through a crowdfunding campaign with contributions as low as 20 pounds.[1] If it succeeds, it will become a listed company.

Will Oulton then called for the design of a transparency policy with a reporting component to ensure the social purpose of capital (e.g « how does this investment fit the environmental agenda? »). There is a need to engage and increase ESG awareness among investors to make a case of its financial and political relevance he said. For the success of the Capital Markets Union SRI must be at the heart project and not on the margins.

IV. Measuring the impact of ESG factors on investment decisions and for the energy and ecological transition

Anne-Catherine Husson-Traore, CEO of Novethic then took the floor to first present Novethic. A subsidiary of Caisse des Depots and a research and media expert in sustainable finance, Novethic has conducted many SRI market studies and it issued the first European funds' certification scheme, the "Novethic SRI label" in 2009. It also recently engaged in interactive training and empowerment activity.

Mrs Husson-Traore presented the study conducted in 2016 by Novethic for the "2015 figures of Responsible Investment in France".[2] Since Novethic was founded, 15 years ago, the French Responsible Investment market, as a whole, has grown 30 folds. In 2014 it comprised €578 billion and increased up to 29% in 2015 to reach €746 billion[3]. It is an innovative market with several approaches, often combined by the firms (Best-in-class, Themed investments, ESG constraints, Financial valuation). ESG integration (Financial valuations and ESG constraints) now has penetrated the strategy of large asset owners such as all the French major insurance companies. This raises the question: what is the effective impact?

This question is at the heart of the research conducted by Novethic. To that end Novethic combined a quantitative and qualitative analysis of the funds and divided the French €746 bn market into three categories:

- Limited impact: assets to which ESG constraints are applied, where less than 25% of investments are excluded based on ESG criteria. With €542 bn they account for 75% of the market
- Significant impact: assets managed under a financial valuation or best-in-class approach, which exclude between 25% and 50% of the investment universe. With €150bn, they account for 20% of the market.
- High-impact: ESG best-in-class approaches that exclude more than half of the investment universe and best-in-universe approaches that exclude more than 25% of securities and themed investments. With €54bn, they account for 7% of the market. A limited market share but it shows very promising growth, the retail/private banking clients showing a growing interest for tangible sustainable investment solutions.

Mrs Husson-Traore then addressed the matter of funds quality standards which aim at gaining (retail) customers trust towards sustainable investments. She presented 4 labels to which Novethic is attached. It created the "Novethic SRI label" in 2009 and the "Novethic Green Fund label" in 2013. It

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[1] For more information on the "People's Trust" : https://www.thepeoplestrust.co.uk/

[2] See the study : http://www.novethic.fr/fileadmin/user_upload/tx_ausynovethicetudes/pdf_complets/2015-figures-on-RI-in-France.pdf

[3] Assets held by French investors and managed in France and internationally. It does not cover assets of foreign investors managed in France.

is also strategic partner and the sole auditor for the German Forum for Sustainable Investments (*Forum Nachhaltige Geldanlagen,* FNG) sponsored SRI label and accredited auditor of the French Environmental Ministry sponsored "French Label for the Energy and Ecological Transition" SRI label (*Label pour la Transition Energétique et Ecologique pour le Climat,* TEEC). Mrs Husson-Traore described at length the TEEC label. There are four categories of eligible asset classes (listed equity funds; green bond funds; private equity funds; infrastructure funds) and several requirements for labelling (assets must be invested in green activities as defined by the Climate Bonds Initiative (CBI) taxonomy). The label excludes sectors such as fossil fuels, nuclear power and controversial companies.

She then addressed the impact of the 2015 French Energy Transition Law on the market trends and the momentum it generated towards transparency. A broad base of asset managers and asset owners is now due to disclose their ESG considerations and the largest must also disclose their climate strategies. This national initiative can also very well be articulated with International agreements such as the Montréal Pledge launched in September 2014: 120 signatories worldwide, representing €10trn, have committed to define a climate strategy. Mrs Husson-Traore emphasized the fact that better climate-change awareness is a game changer in terms of volume of assets under an SRI approach. But several initiatives as mentioned earlier (transparency with the 2015 French Energy Transition Law, guidance with the TEEC label) can also encourage green investment allocation. In this context, she opened the debate for a European initiative in this field.

V. Sustainable Investment Approach for KfW`s Liquidity Portfolio

Rita Geyermann**,** Head of Asset Management, at German *Kreditanstalt für Wiederaufbau* (KfW), then took the floor for a presentation of the sustainable investment approach for KfW's liquidity portfolio.

First Mrs Geyermann presented a few thoughts on sustainable investing. She declared that it was becoming mainstream, due to a growing acceptance among investors. KfW is responsive to this context with a sustainable investment approach which differs to the traditional approach in adding to the consideration of financial and business risks the consideration of ESG risks such as climate change, health and safety, bribery, fraud and corruption. Mrs Geyermann insisted on the financial relevance of ESG events on a company's risk profile. To this end, she cited two examples of ESG events which led to higher financing costs: the Deepwater Horizon oil spill in 2010 (Environmental) whose impact on BP's financing cost is still visible today and the Volkswagen emissions scandal (Governance) which has also impacted its risk profile and therefore its financing cost. She reminded the audience that governance risks can also have a negative impact on banks, with litigation payments reaching up to USD 274bn for the major global banks between 2009 and 2015 (US sanctions on trade, FX and LIBOR rigging, violations of US federal and state securities laws in connection with mortgage-backed securities). But ESG consideration can also be a tool to improve credit quality analysis and therefore better manage downside risks. It can also contribute to excess return. Mrs Geyermann cited a study from Barclays[4] on this subject. It showed that investment-grade portfolio with higher ESG score outperformed the portfolio with low ESG score between 2009 and 2016. But the challenge to ESG integration is that these risks may be significant in terms of business risk but might not necessarily rapidly impact the credit rating of an issuer.

Mrs Geyermann then moved to the specific case of KfW. She stressed that sustainability is embedded in KfW's business model with promotional activities which aim at improving the economic, ecological and social living conditions. KfW is one of the world's largest financiers of environmental investments[5] with around EUR 200 bn invested worldwide since 2006 and signed the Principles for Responsible

[4] Albert Desclée, Lev Dynkin, Jay Hyman and Simon Polbennikov, *Sustainable investing and bond returns*, Barclays Research, October 2016
https://www.investmentbank.barclays.com/content/dam/barclaysmicrosites/ibpublic/documents/our-insights/esg/barclays-sustainable-investing-and-bond-returns-3.6mb.pdf
[5] Bloomberg – New Energy Finance 2015

Investment (PRI) in 2006. KfW engaged in a sustainable investment approach for its EUR 24bn liquidity portfolio in 2008, taking inspiration from the PRI. The portfolio is composed of government bonds, covered bonds, financials, bonds issued by government-related issuers and agencies and Asset Back Securities (ABS). The sustainable approach combines three principles:

- An assessment based on ESG criteria completed by a sustainability rating agency. The sustainability score is used as basis to determine whether the limit for a bond issuer provided by the credit risk department can be fully used or is subject to a haircut. The exclusion of bonds from issuers who are in not compliance with specific exclusion criteria which are based on the International Finance Corporation (IFC) exclusion list;
- A regular dialogue with the issuers and a letter informing them of their ESG score and its impact on the limit volume.

This approach contributes to KfW being awarded with top sustainability ratings. Currently, KfW is ranked third among 393 banks worldwide by research and sustainability rating agency *Sustainalytics*.

VI. Q&A and closing remarks

The dinner-debate then moved to questions from the public.

Helmut von Glasenapp, Secretary General of the European Long Term Investors Association (ELTIA) inquired whether national initiatives such as the French of British ones, mentioned earlier, could have an impact abroad. Anne-Catherine Husson-Traoré, from Novethic, claimed that climate change awareness favoured initiatives throughout the EU with a variety of approaches though. She cited the integration of ESG criteria into Blackrock's investment policy and their consideration by the French *Fédération Nationale des Agents Généraux d'Assurance* (AGEA, National Federation of Unions representing General Insurance Agents) but to a lesser extent. Will Oulton, from Eurosif, mentioned the UK Stewardship Code which is being replicated in twelve countries around the world. Some national initiatives can be seen as best practices. Rita Geyermann, from KfW, agreed with the international momentum but regretted that Germany lags behind.

MEP Pervenche Berès, S&D coordinator for the ECON Committee, then asked Olivier Guersent whether the European Commission would take inspiration from initiatives from the Member States.
Olivier Guersent believes it is too soon to contemplate action from the European Commission regarding an EU-wide SRI labelling scheme. He claims we should let the market and local public actors take the initiative. The best standards can naturally emerge in the market and the Commission may assist them through soft law but there are no immediate plans for action on this regard.

Joost Mulder, Head of Public Affairs at Finance Watch, inquired about possible projects for "green securitization" in the context of the "Simple, Transparent and Standardised (STS) Securitisations" initiative. Olivier Guersent demonstrated the same opposition that he did earlier regarding the Green supporting factor. He cannot support it, if based solely on political motivations.

Anne-Catherine Husson-Traoré then asked how to steer the massive capital in the world towards the investment gap to finance the energy transition. Rita Geyermann said we need to increase SRI awareness among the financial institutions and to promote a long-term perspective when investing because both notions are mutually dependent. Will Oulton added that every financial product should have a statement of social purpose.

MEP Pervenche Berès then gave a few closing remarks. She warned that as beneficial for society and for the legitimacy of European integration, initiatives regarding SRI may be, they have little weight compared to the detrimental effect of former President of the European Commission Jose Manuel Barroso's recent appointment at Goldman Sachs.

She then recalled a conversation with former MEP Robert Goebbels where he pointed out the contradiction between genuine interest from consumers in SRI and equally genuine interest in getting the best possible returns for their investment.

She commended the adoption of the directive on country-by-country reporting after long and persistent efforts. She then took the example of the STS initiative to illustrate the possibility for MEPs to promote important topics even when they're not directly related to a given regulation. For instance, there could be a provision preventing securitization from operators in tax heaven or outside the European Union linked to child labor. The STS initiative should not be unidimensional. Pervenche Berès also commended Mr Guersent's earlier remarks on the IFRS foundation and the IFRS 9 standard. She claimed it was inconsistent to promote SRI while excluding it from negotiations around IFRS 9. She cited a recent meeting between heads of the IFRS foundation and MEPs from the working group on IFRS 9 in the ECON Committee, during which MEPs were told that considering long-term investments in the design of the standards was not part of the IFRS foundation mission and that the staff from the IASB did not understand the attention of the MEPs. She regretted that the retail investors' perspective was not addressed in the dinner-debate as many retail investors want to engage in SRI as well. Finally Pervenche Berès recognized that extra-financial reporting was important but claimed that the debate around hard and soft law can't be escaped as there needs to be a solid labelling scheme, so that we can avoid the issue of greenwashing. Finally she wondered about the interlink between SRI and taxation (incentives and deterrence). Would tax evasion constitute poor ESG performance?