European Commission - Fact Sheet

Frequently asked questions: Commission proposals on financing sustainable growth

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Why is there a need for an EU-wide strategy on sustainable finance?

The signature of the Paris Agreement on 12 December 2015 and the adoption of the UN 2030 Agenda for Sustainable Development on 25 September 2015 marked a shift in global attitudes towards climate change and environmental degradation. The fact that over 170 countries have now ratified the Paris Agreement sends a powerful signal: the necessity of transitioning to a low-carbon, resource-efficient and circular economic system can no longer be ignored.

To achieve the targets agreed in Paris, including a 40% cut in greenhouse gas emissions, around €180 billion of additional investments a year are needed. The scale of this investment challenge is beyond the capacity of the public sector alone. The financial sector has a key role to play in reaching those goals, as large amounts of private capital could be mobilised towards sustainable investments. Capital markets, in particular, are key channels of private capital and can help to reorient investments towards thosesectors and activities that can contribute to the sustainability of our economy and transition.

Fostering more sustainable private investments was a key priority of the Capital Markets Union's (CMU) mid-term review. The Action Plan on Financing Sustainable Growthlaunched by the Commission on 8 March 2018 laid out a roadmap to deliver on this commitment. We need to ensure that the regulatory framework helps the financial sector adjust to the risks of climate change and environmental challenges, and fosters private capital flows towards sustainable investments. With this Action Plan, the Commission is determined to lead global work in this area and help sustainability-conscious investors choose suitable projects and companies.

The EU is also already providing a massive impetus to maximise the impact of public funds to attract more private investments. In particular, the extended and reinforced European Fund for Strategic Investments (EFSI 2.0), in force since 31 December 2017, proposes a 40% climate-smart investment target.

What are the objectives of the Action Plan on Financing Sustainable Growth?

The Action Plan aims to further connect finance with the specific needs of the European and global economy for the benefit of the planet and our society. The Action Plan has three objectives:

1. Reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth;
2. Manage financial risks stemming from climate change, natural disasters, environmental degradation and social issues; and
3. Foster transparency and a long-term outlook for financial and economic activity.

To achieve these objectives, the Action Plan lists a series of actions which should be implemented by 2019.

How are today's proposals linked to the Capital Markets Union (CMU)?

The CMU is one of the priorities of the Juncker Commission to strengthen Europe's economy and stimulate investments to create jobs. It aims to diversify capital flows by channelling market-based finance to all businesses in the EU, particularly innovative companies.

Building on progress already achieved since the launch of the CMU in September 2015, today's proposals will better connect markets with the real needs of the European economy, in particular the necessity of reorienting flows of capital towards sustainable investment. The mid-term review of the CMU Action Plan of June 2017 stressed the role that capital markets can play in financing the transition towards a more circular economy. Today's announcements also create a solid basis for an EU-wide market for sustainable investments, supporting the integration of risks stemming from environmental and social sustainability into long-term investment decisions.

The Commission is committed to putting in place all building blocks of the Capital Markets Union by mid-2019. The measures presented today, and the remaining CMU proposals that will be presented by end of May 2018, should be adopted before the European Parliament elections in 2019.

What is the Commission proposing today and why?

Today's ambitious package of measures aims to:

- Provide clarity on what sustainable investments are by creating **an EU-wide classification system or taxonomy** to provide businesses and investors with a common language to identify what degree economic activities can be considered environmentally-sustainable. This is a first and essential step in efforts to channel investments into sustainable activities.
- Ensure that **asset managers, institutional investors, insurance distributors and investment advisors include economic, social and governance (ESG) factors in their investment decisions and advisory processes** as part of their duty to act in the best interest of investors or beneficiaries. Asset managers and institutional investors who claim to pursue sustainability objectives would have to disclose how their investments are aligned with those objectives. This means greater transparency towards end-investors, ensuring comparability between products and discouraging 'green-washing' or misleading information.
- Create a **new benchmark category for low-carbon and positive-carbon impact benchmarks**, fostering a generally accepted market standard to measure a company's footprint and, in consequence, an investment portfolio's carbon footprint. This would give investors who want to invest in low-carbon strategies an appropriate tool to enable them to compare the performance of their investment.
- Ensure that investment firms and insurance distributors **integrate sustainability preferences into their suitability tests when offering advice to investors** and that the products offered meet their clients' needs.

I. TAXONOMY

Why do we need an EU environmentally-sustainable classification system?

An EU environmentally-sustainable taxonomy would identify which and to what degree economic activities can be considered environmentally-sustainable. It would determine the conditions that those economic activities would need to comply with to positively contribute to at least one of the six EU environmental objectives as set out in the Regulation: 1) climate change mitigation; 2) climate change adaptation; 3) sustainable use and protection of water and marine resources;4) transition to a circular economy, waste prevention and recycling; 5) pollution prevention and control; and 6) protection of healthy ecosystems.

No classification system currently exists at EU level which clarifies what constitutes an environmentally-sustainable economic activity. Market-led initiatives thathave emerged in recent years are not comprehensive enough and do not sufficiently reflect all EU environmental sustainability priorities. While some Member States have built on these market initiatives to develop classifications for climate-related or environmental economic activities, they serve only as a basis for national standards and labels. An EU-wide, environmentally-sustainable taxonomy would help overcome two problems:

- Market-based initiatives and national practices which are not generally developed in a coherent manner are likely to give rise to divergent classifications, as they pursue national policy agendas targeting only relevant aspects for the local industry. This fragmentation is confusing for investors, especially retail investors who would like to invest in more sustainable activities. The divergent criteria as to what qualifies a sustainable activity are an obstacle to a single market for sustainable investments.
- Greenwashing - the practice of financial products being marketed as 'green' or more generally 'sustainable', when in fact they do not meet basic environmental standards. Diverging classifications of economic activities with varying scopes and based on different criteria and metrics leave a lot of scope for greenwashing, with a direct negative effect on the functioning of the internal market as it undermines investor confidence in the market for sustainable investments.

When is an economic activity to be considered environmentally-sustainable? What is the process for establishing an environmental taxonomy?

In order to qualify as environmentally-sustainable, economic activities would have to fulfil all the following requirements:

- contribute substantively to at least one of the six environmental objectives laid out in the proposal;
- not significantly harm any of the other environmental objectives;
- be carried out in compliance with a number of minimum social and governance safeguards;

- comply with specific technical screening criteria.

The Commission would specify the qualitative and quantitative technical screening criteria for each economic activity through delegated acts. For example, they would need to be based on available and conclusive scientific evidence, be proportionate to the nature and the scale of the economic activity and build on existing taxonomies.

The **environmental taxonomy** will be established in two stages. The first step is the proposal for a Regulation adopted today, which:

- lays out conditions for identifying environmentally-sustainable economic activities;
- defines the six EU environmental objectives to which economic activities will have to contribute to be considered eligible; and
- empowers the Commission to establish technical screening criteria and frames how these criteria would have to be defined.

As a second step, the Commission will establish through **Delegated Acts** the technical screening criteria on the basis of which it will be determined if and to what extent an economic activity is environmentally-sustainable. This would be done on the basis of the advice from the technical expert group, which is currently being established by the Commission for that purpose.

Who will be affected by the taxonomy?

The taxonomy, once developed, will have to be used by:

A) **Regulators at national and EU level when setting requirements on market actors** regarding financial products that are marketed as environmentally-sustainable (such as labelling schemes).

B) **Financial market participants offering financial products as environmentally-sustainable.** They would have to disclose information on the criteria used to determine the environmental sustainability of the investment.

In practical terms the proposed regulation does not prescribe to market participants what to invest in. While the proposal creates incentives to invest in green activities, it does not in any way penalise other investments.

The operational part of the Regulation and the detailed taxonomy will not apply until 6 months after the adoption of the relevant future delegated acts by the Commission. This will allow market participants to have more time to prepare for the application of the new rules.

II. INVESTORS DUTIES AND DISCLOSURES

What are the current rules on sustainability for financial actors such as institutional investors, asset managers and advisers, and why do they need to change?

Under the current rules, financial entities that receive a mandate from their clients and beneficiaries to make investment decisions on their behalf or to provide recommendations to their clients have the duty to act according to the best interests and expectations of their clients and beneficiaries and in compliance with the mandate received.

However those rules are neither always clear nor consistent across sectors when it comes to sustainability opportunities and risks. This was confirmed by respondents to the public consultation on long-term and sustainable investment. There is also a lack of transparency on how these entities consider sustainability factors and risks in their investment decision-making and advisory process. As a result, investors may not get the full information they need to inform their decisions.

What is the Commission proposing on the ESG duties of financial actors?

The Commission is today proposing a harmonised EU approach to the integration of ESG risks and opportunities in the procedures of institutional investors, asset managers, insurance distributors and investment advisors, as part of their duty to act in the best interest of clients. It also sets uniform rules on how those financial market participants should inform investors about their compliance with the integration of ESG risks and opportunities. The proposed harmonised approach builds on existing rules by aligning the requirements to the above-mentioned financial sectors in a consistent manner. The current rules set in various sectoral EU legislations will be further specified through delegated acts to be adopted by the Commission.

Which financial actors and financial products will be affected?

The proposed regulation will apply to the following entities:

- asset managers, regulated under the directive on undertakings for collective investment in transferable securities (UCITS), the alternative investment fund managers (*AIFM*) directive, the European venture capital funds (EuVECA) and European social entrepreneurship funds (EuSEF) regulations;

- institutional investors:

o insurance undertakings regulated by Solvency II

o occupational pension funds regulated by the institutions for occupational retirement provision directive (IORP II)

- insurance distributors regulated by the insurance distribution directive (IDD)
- investment advisors and individual portfolio managers regulated by Markets in financial instruments directive (MiFID II).

The proposed rules cover all financial products offered and services (individual portfolio management and advice) provided by the above-mentioned entities, regardless of whether they pursue sustainability investment objectives or not. An EU low-carbon index or a positive-carbon impact index would be designated as a reference benchmark only for those products/services pursuing a low-carbon emission objective.

What disclosures will the financial actors have to make and for which products?

The Commission proposal requires disclosure of:

- the procedures financial actors have in place to integrate ESG risks into their investment and advisory process; and
- the extent to which ESG risks are expected to have an impact on the returns of the product or service provided, irrespective of whether or not sustainable investment objectives are pursued.

In addition, if asset managers or institutional investors claim that they pursue a strategy with sustainability investment objectives, they will have to provide information on how they adhere to those sustainability objectives in their investment decisions. This includes the disclosure of the sustainability or climate impact of their products and portfolios. This should in practice limit possible "greenwashing" – i.e. the risk that products and services which are marketed as sustainable or climate friendly in reality do not meet the sustainability/climate objectives claimed to be pursued.

III LOW-CARBON AND POSITIVE-CARBON IMPACT BENCHMARKS

Why does the Commission propose to create new benchmarks?

Benchmarks have an important impact on investment flows. Many investors rely on them for the creation of investment products, for the measurement of performance of investment products and for asset allocation strategies. However, the Commission has identified a lack of appropriate and objective low-carbon indices that could be used as a reference index. In addition, there is presently a high risk of 'greenwashing', as the levels of disclosure of the methodologies are very different. Greater transparency and guidance is needed to ensure investors use and select benchmarks in a manner that is consistent with long-term investment strategies, which does not impede sustainability strategies and helps to drive allocation of capital towards more sustainable investments.

The Commission proposes to create a new category of benchmarks, comprising **low-carbon** and **positive-carbon impact** benchmarks.

What is the difference between these two types of benchmarks?

One new category, comprising two types of benchmarks, will be defined by the Benchmark Regulation: (i) low-carbon benchmarks and (ii) positive-carbon impact benchmarks.

1. The **low-carbon benchmark** is based on 'decarbonising' a standard benchmark (e.g., an equity index like the Standards and Poor's 500). The underlying stocks would be selected on account of their reduced carbon emissions, when compared to stocks constituting a standard benchmark.

2. In contrast, **the positive-carbon impact benchmark** is a more ambitious version aligned with the second Paris agreement objective. The underlying stocks are selected on account of their carbon emission savings exceeding the stocks' residual carbon footprint. This is the only type of benchmarks that would be compliant with the 2° objective in the Paris Climate Agreement.

While addressing the main challenges related to low-carbon benchmarks, this proposal provides flexibility for benchmark providers, as it will not force them to use the second type of benchmark. Instead, they will be free to provide a full spectrum of low-carbon benchmarks, which will set a different degree of ambition with respect to meeting climate-related objectives (e.g. 3, 4 or 5 ° scenarios of emission reductions). Besides, where no EU low-carbon benchmark or positive-carbon benchmark is available, a detailed explanation will have to be provided on how continued adherence to the target of reducing carbon emissions will be ensured. This may foster a generally accepted market practice to measure a company's footprint and therefore an investment portfolio's carbon footprint, while keeping sufficient flexibility for the private sector to innovate. This will provide investors with a reliable tool to pursue low-carbon investment strategies.

What about other ESG benchmarks?

Benchmark administrators who produce ESG benchmarks should disclose how they take account of environmental, social or governance considerations.

IV SUITABILITY TESTS

How does the Commission propose to include ESG considerations in suitability tests?

MiFID II and the IDD require investment firms and insurance distributors to obtain the necessary information about clients' investment objectives prior to providing products. This information includes the length of time the investor wishes to hold the investment, preferences regarding risk taking, risk profile, or the purpose of the investment. Based on this information, firms assess which products are 'suitable' to meet their clients' needs (suitability tests). Currently, firms do not always assess investors' non-financial preferences, such as their preferences concerning environmental and social impacts of the investment.

The amendments to MiFID II and IDD delegated acts, for which a public consultation is launched today, would require investment firms and insurance distributors to ask their clients about their preferences as regards ESG, and then to take them into account when advising their clients, as part of the product selection process and the suitability assessment. Based on these delegated acts, the Commission will invite the European Securities Markets Authority (ESMA) to include provisions on sustainability preferences in its guidelines on the suitability assessment (which should be updated by Q4 2018).

How will the technical expert group on sustainable finance help further develop the legal framework on sustainable finance?

The Commission is currently setting up a technical expert group on sustainable finance. Its mandate will be to:

(1) prepare a report providing a taxonomy for climate change mitigation and adaptation and other environmental activities – i.e. notably defining the technical screening criteria that will identify economic activities which contribute to climate change mitigation and adaptation in a first step;

(2) issue a report on an EU Green Bond Standard, laying out the criteria and processes green bond issuers should adhere to, including the use of the EU classification system;

(3) issue a report on the design and methodology of a low-carbon benchmark;

(4) develop climate-related metrics for the purposes of corporate reporting.

Once the legal framework on taxonomy is in place, the Commission will establish a platform on sustainable finance composed of relevant stakeholders from both the public and private sector.

What is the timetable?

The Action Plan on Financing Sustainable Growth includes a timetable for all actions that will be rolled out by Q2 2019.

The first delegated act covering the climate change adaptation and mitigation objectives could be adopted by year-end 2019, on the basis of reports from the technical expert group on sustainable finance. The objective would be to adopt the second and third delegated acts by mid-2021 and mid-2022 respectively covering other four other environmental objectives (protection of water and marine resources, circular economy and waste management, pollution prevention and control, protection of water and marine resources, healthy ecosystems). The EU environmental taxonomy would then be completed.

Subject to the outcome of the review of the proposed Regulation on taxonomy (at the earliest three years after entry into force of the proposed Regulation), the scope of the taxonomy would also be expanded to socially sustainable activities.

In Q2 2019, the Commission will publish its fitness check of EU legislations on public corporate reporting and amend its non-binding guidelines on non-financial reporting. The Commission will also adopt a delegated act on the content of the prospectus for green bond issuances and publish a comprehensive study on sustainability ratings and research.

Following the adoption by the co-legislators of the Regulation on the EU sustainability taxonomy, the Commission will create EU Ecolabels for financial products and explore possible measures to incorporate climate and environmental risks into prudential requirements in line with the EU taxonomy.

What preliminary work has the Commission conducted?

The proposal is the result of desk research, stakeholder consultations and the contributions made by the High-Level Expert Group (HLEG) on sustainable finance, set up by the Commission at the end of

2016. The group prepared a comprehensive blueprint for reforms along the entire investment chain, which was published on 31 January 2018. The HLEG report offers a comprehensive vision on which elements should underpin a sustainable finance strategy in the EU. The report proposed eight key priorities, including several cross-cutting recommendations and actions targeted at specific sectors of the financial system. The Commission's Action Plan builds on these elements and further develops them for an EU strategy on sustainable finance.

What are the next steps?

The proposals will now be discussed by the European Parliament and the Council.

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