SFL response to the questionnaire of the EU HLEG on Sustainable Finance[1], September 2017

Question 1. From your constituency's 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)

First, the focus should be on the entire investment/loan portfolio of the sector and its practices, not only on the niche of sustainable finance. It is 'mainstream' lending and investments that currently drive and support highly unsustainable social and ecological trends. Sustainable finance requires engagement with and divestments of unsustainable companies.

Second, the recommendations need to go beyond increasing transparency and also address incentives. As the report rightly states, there is no inherent tradeoff between sustainability and financial return and most asset owners want their investments to also have a positive social and ecological impact. However, mandates, contracts and common practices within the investment chain currently do not yet reflect this fully. As a result, sustainability plays a much smaller role in the actual investment decision than asset owners prefer and than should be warranted from even a purely financial risk and return perspective. To change the mind-set an incentive will accelerate the transformation.

Thirdly, the sector also needs a clear and ambitious timetable to facilitate the coordination between different actors. Otherwise the danger is that all players are waiting for one another party to act first. For example, companies do not report adequately on ESG as they feel their investors do not take ESG data into account, and vice versa.

Fourth, the focus should not be exclusively on climate. There are other environmental themes (like the nitrogyn cycle and biodiversity loss) that threaten human wellbeing and thus financial returns and stability. These each face specific challenges that financial institutions need to act upon. They are interdependent as becomes increasingly clear.

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

All asset classes and financial products should be included in an EU taxonomy. However, it is almost unthinkable that any taxonomy would ever be capable of fully covering the multidimensionality and complex interactions that arise when considering sustainability. The evaluation and measurement of an asset(class)'s "sustainability" is inherently a judgement call in which many, possibly opposing, aspects need to be weighed and evaluated in a holistic way. The only way to handle such complex decision making is to involve a broad group of stakeholders continuously discussing specific cases and drawing general lessons to develop a shared body of knowledge on how to evaluate sustainability and weight opposing interests. Whatever taxonomy one decides to develop, it therefore has to be build upon and include an ongoing broad stakeholder dialogue.

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?

[1] As the format of the HLEG limited the responses to 1500 characters some questions have been edited to fit the form.

Crucial is the data that is available from companies. These need to be complete, coherent and forward looking with regard to all material issues and information. Not only with regard to carbon but also on biodiversity, water, land use and other material ecological and social issues. Currently reporting on environmental impact, dependencies and the impact on social conditions is far from complete. Whereas especially carbon emissions are widely seen as a material factor for some years now, also here the reporting is insufficient and does not address investor's need to make informed decisions. Especially on scope 3. For other forms of natural capital (water, biodiversity and land use) the situation is much worse (Maas et al 2017 Investors and Companies' Biodiversity and Natural Capital Reporting and Performance).

This seems to be a direct violation of accounting standards that demand that all material information is reported. The EU should guard the implementation of its rules on non-financial reporting (Directive 2014/95/EU) by sanctioning companies in sectors for which natural capital is material (for instance according to the SASB materiality map) if they do not adequately report on this along the lines as set out in the guidance of the European Commission of June 27 2017.

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 / no opinion / not relevant

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?

We strongly support the identified policy direction of strengthening the ownership chain by providing model sustainability clauses that asset owners can include in their asset management agreements. This could fundamentally change the, currently often myopic and exclusively financially oriented, incentives in the investments chain. The mandates that asset owners give to asset managers should include clear principles/investment beliefs on the materiality of ESG and the need of a long term orientation. This needs to be translated into clear agreement on how ESG is integrated in the investment decision, in stewardship (engagement and voting), in the choice of (sustainable) benchmarks and how the asset manager reports on this. The contract should also have a fee and pay structure that is long term oriented and includes ESG performance. Also a reduction of the reporting frequency of asset managers may help to create a more long term oriented investment culture.

Supervisors and regulation should stimulate this development by focusing more on rewarding long term incentives in mandates rather than detailed regulation of the investment process itself. Regulation can be a source of short termism itself as it often builds on theoretical notions of the efficient market hypothesis that make it more sensitive to short term market sentiments than to underlying value drivers and gives too much weight to short term liquidity indicators.

Through public policy long term oriented investments can be incentivised for instance through the introduction of the possibility of loyalty dividend and/or voting rights.

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

Firstly, by making strong and credible policy commitments to sustainability targets, underpinned with policies to achieve these. Think of regulation to increase the energy efficiency of the industry and real estate or to reduce the waste that is dumped. Also the governments own tendering can be used much more intensively.

Specifically with regard to private finance, it can help by clustering smaller projects into larger projects and focusing on synergies. Currently urgently needed small projects in different European cities and regions are ignored or dismissed by large investors because of their size. By clustering the EU can also contribute to knowledge and experience how to cluster smaller projects and make them more attractive for the private sector in the long term.

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

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

The current models on which capital requirements are based have been developed in a time where sustainability was not, or hardly, taken into account in financial risk management.

In recent years a consensus has emerged that ecological stress, most prominently climate change but also the depletion of virgin materials, biodiversity loss, water scarcity etc. does have a material effect on most critical economic sectors (see Maas et al 2017 “Investors and Companies’ Biodiversity and Natural Capital Reporting and Performance”)

Most of the available research concludes that more sustainable investments on average have a lower risk profile. Unsustainable investments hence are more risky. This higher riskiness can be expected to increase sharply in the coming years, as the shock materializes of either transgressing social and ecological boundaries (physical effect of climate change or resource depletion) or of public policies and/or technological developments that help to stay within these boundaries (‘carbon bubble’ like scenario).

These adjusted risk profiles should be reflected in the capital requirements of banks or in caps, large exposures restrictions, that set an absolute limit on the financing of ecological risky companies (and sectors) (see Schoenmaker et al 2015 What role for financial supervisors in addressing systemic environmental risks?)

We recommend to use Pillar II and Pillar III to address these issue more exhaustively on the level of the individual bank. Also Pillar I would need to adapt to the new reality of increased sustainability risks.

What these adjustments need to be is a matter of further research. To calibrate the instruments needed are (scenario)studies that provide insight in this impact of sustainability on risk.

Most probably, this would lead to a higher risk weight to unsustainable assets as these are most strongly exposed to the so called transition risk.

By increasing the risk weights of unsustainable assets the overall capital position of banks will also improve, something that most academics have been advocating for in recent years.

Adjustments of Pillar I may also be warranted from a systemic point of view. As has been done for SME loans, reflecting the risk to the economy when SME’s have a lack of finance. The same logic may apply for loans that support the sustainability transition.

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

Being the largest investors in the EU it is particularly worrisome that insurers in the EU have fled from companies equities and long term finance in favor of government debt (regarding equities to a much greater extent than US insurers) It needs further consideration what role the different prudential and accounting regime has played in this. However, given their long term liabilities the insurers are well positioned to play a much more prominent role in financing the sustainability transition than they are currently doing. To fulfill their role to the full, insurers should also play an active stewardship role, inducing their investee companies to explicitly address how they react to the risks and opportunities that the different sustainability transitions poses.

Moreover, for a specific part of the insurance industry, the liabilities are more or less directly linked to the success of the transition. Insured damages from flooding, extreme weather, soil depletion and drought are rising. It is not clear (yet) that this can be attributed to climate change, but it should motivate insurance companies and reinsurers to act proactively.

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

Social aspects are an integral part of sustainability. Ecological transitions will have strong redistributive effects and need the support of the people. With income and wealth inequality at such historical high levels and so short after the financial and economic (euro)crisis there are large groups in society that are financially vulnerable. For economic reasons (sharing the financial benefits) but also to enhance social cohesion, people should be actively made part of the transition to a more sustainable economy. We therefore recommend to promote an attractive sustainable retail offering (see Schoenmaker (2017) 'Investing for the common good' and Triodos Bank (2014) 'Impact Investing for Everyone')

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?

The interim report mentions the need for protection of those who take long-term investment decisions in the face of short-term pressures from financial markets. We strongly support this. A clear example are companies with a long term vision that are threatened by a hostile takeover bid. This is especially acute in the current market conditions of ample liquidity and low interest rates, fueling an M&A-boom. An M&A boom that as history has shown leads to wealth destruction as over 100 studies from EU, US and Japan have shown that on average 75% of M&A's fail.

The question is what European rules can provide the needed protection. Rules should not take the investors fully out of the equation, but should prevent that hasty decisions are taken because of short term financial considerations that have a big negative impact on the wider society. This could be along the lines of the current Dutch proposal of a "legal timeout" for hostile takeovers and/or in combination with a public interest test of M&A above a certain threshold (like in Germany of 400 million euro).

Taking out the discipline of the market, however, should be compensated by a stronger framework for alternative sources of external control and accountability. If managers are less accountable to investors, they should be to the owners of the firm and society at large in different ways.

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

What we miss is a more pronounced acknowledgement of the importance of a more diverse financial system. This is important for the resilience of the financial sector, and thus the continuity with which it can contribute to the sustainability transition.

But specifically for the EU, with its relatively strong bank based financial system, more diversity in the sense of more equity finance is also important to finance the innovative and thus risky enterprises that drive the sustainability transition.

To increase diversity we need to reduce the current advantages of (big) banks like the implicit subsidy they get from their too big to fail status and the fiscal advantages of debt finance over equity finance. The banking union addresses the first issue to some extent, but risks also encouraging further consolidation homogenization and thus even more systemically important banks.

Several EU members have taken steps to decrease the fiscal advantage of debt financing but so far an EU strategy is missing, while there can be large advantages to this in terms of both mutual learning and coordination in order to level the playing field.

Also specific attention is warranted for new players and new financial products. Fintech, crowdfunding, credit unions and others increasingly play a much larger role in other financial systems and that seem particularly well suited to finance sustainable innovations.

Important is also to look at the intrinsic motivation of the people working in, and especially those leading, the financial institutions. The Dutch Central Bank (DNB) has started a program on culture and behavior in financial institutions and pays more attention to this in their qualifications of potential board members. This could be introduced EU-wide in the context of the Single Supervisory Mechanism.

Financial firms should follow the lead of real sector firms that have oriented their long-term strategy on a well-defined purpose.