UKSIF
UK Sustainable Investment and Finance Association

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Dear Mr Thimann,

I am writing in my capacity as Chief Executive of the UK Sustainable Investment and Finance Association (UKSIF) with regard to the High Level Expert Group (”HLEG”) on Sustainable Finance.

I would like to start by congratulating you and the entire HLEG team on the excellent progress made to date. We and our members fully support the intent of the project.

This letter outlines UKSIF's position on the questions posed in the HLEG questionnaire and is the result of extensive consultation with our membership. This has included a webinar, a roundtable event and various in-person meetings and calls. This letter incorporates those views and comes in addition to a response via the electronic feedback form on the European Commission website. The issues dealt with in the interim report are wide-ranging and we hope they will shape sustainable finance in Europe for years to come. This means that a 1500 character limit per question is simply not enough for us to present the views of our membership to the HLEG. While we appreciate the limited resources of the HLEG, this is a process which cannot be rushed and we believe the group has a duty to consider all feedback in full.

Introductory remarks and observations

We welcome the work of the HLEG and the intentions behind it. International co-operation to boost understanding of sustainable finance is to be welcomed and UKSIF members are keen to be fully engaged. We are making sure the UK Government is aware of the work and with today's announcement of Government endorsement of the TCFD recommendations and the setting up of a Government task force on green finance we would hope for a favourable reception for innovative, well thought and, above all, effective action by the EU. There are clear benefits in Europe's leading financial centre and the EU remaining closely aligned in this crucial area.

We are tremendously encouraged by the interim HLEG report. If the HLEG's final recommendations reflect expert opinion and input we would anticipate that they will offer practical, actionable guidance backed by legislative and regulatory drivers. We would expect to promote their thrust and to lobby for them to be mirrored in the UK.

A European taxonomy for sustainable financial products

An accurate and effective EU wide taxonomy for sustainable assets and financial products is crucial if European standards and labels which deliver change are to be agreed. A taxonomy has the potential to boost confidence in sustainable finance and thus capital flows into both retail and institutional markets. Whilst the lack of common definitions has not been an obstacle to past growth such a taxonomy if it is properly constructed and enjoys the support of practitioners could now stimulate the expansion of sustainable finance throughout Europe. On the other hand a poorly crafted taxonomy will set the industry back. All decisions on inclusion and style should recognise this central fact.

There are clearly challenges with a taxonomy however, and hitherto the approach has not been welcomed in the UK. It is essential that the definitions are broad and reflect established practices in leading markets such as the UK; in the UK, for instance, sustainable approaches are not limited to fund management but are seen in banking and insurance as well. A classification system which is too narrow in its scope will restrict innovation and ultimately be damaging for sustainable finance. In addition to sector and sub-sector breadth the taxonomy should have depth. It must include coverage of terms covering concepts, ideas and processes as well as technical terms.

In considering the content of the taxonomy, UKSIF members have raised the point that it will be important to develop terminology which caters both to retail investors and also to professional and institutional investors. It will be necessary to be clear for whom each item in the taxonomy, and each label and standard is intended since retail and institutional investors will have different needs.

A key point linked to what should be included is that practices and indeed definitions change over time. It is important that the taxonomy process is ongoing. This is particularly important since the taxonomy is bound to be linked to the proposed EU-backed standard and labels and thus to markets which we all want to see evolving and growing. It is inevitable that the definitions agreed upon at this initial stage will need refining. The key parties to be included in the initial definition and ongoing review are the practitioners: initial and ongoing engagement with the sustainable finance sectors in each country is essential.

UKSIF members have suggested that the misuse of language which failing to update the definitions would represent would mean a reputational risk to the sector and a grave risk of miss-selling to clients. One important aspect of the need for a workable updating mechanism was expressed by an UKSIF member who said “currently innovation needs to fight its way into definitions by displacing existing practice since the definitions don’t change. The new system must allow change”.

The taxonomy must also be permissive rather than proscriptive. It should give examples of what might be considered as sustainable, not seek to say that something is. This approach should cover the definition of processes as well as individual terms.

Finally, UKSIF members argued strongly that the taxonomy should include explicit recognition that investors need to generate return, which also encompasses profit and alpha. It is the reason they invest. To ignore this fundamental point could risk undermining the excellent work which has already taken place and the potential for expanding sustainable finance throughout Europe. In the context of the taxonomy it might be necessary that it includes introductory material recognising the role of profit and markets as sources of innovation, such that it is clear that the more detailed definitions of terms, ideas, practices and processes are all to be considered within a permissive, profit friendly environment.

European standards and labels for sustainable assets

While we can only comment on the UK market, the HLEG will be interested to know that during Good Money Week 2016 UKSIF-commissioned research found 63% of the UK public backed a label to identify sustainable financial products. The taxonomy for sustainable assets is intrinsically linked to any European standards and labels (S&L) for sustainable assets. The absence of a single accepted S&L system can create uncertainty and hamper efficiency. We note the high profile examples given of such S&L systems and related taxonomies in existence just in relation to green bonds. These include the Green Bond Principles, the Climate Bond Standard & Certification Scheme and the MDB-IDFC Common Principles for Climate Finance Tracking. The possibility, therefore, that other S&Ls will be created subsequent to the EU-backed standard and label – for green bonds and other sustainable assets – remains, and there is certainly no guarantee that the EU-backed iterations will represent the dominant S&L in Europe.

In respect of green bonds some UKSIF members questioned the need for an entirely new S&L, and whether it would not make more sense for the EU to endorse an existing approach.

There are three key criteria for a successful S&L:

- It must allow (and encourage) innovation
- It must be transparent
- It must be permissive rather than restrictive

We have addressed the need to cope with innovation in our comments on the taxonomy. In short, if the S&L cannot cope with innovation and market evolution it will become obsolete and restrict rather than encourage market growth.

Transparency. This will play a key role in combatting "greenwashing". The aim should be a S&L which adequately covers three aspects of a fund: its aim or intent; the process whereby it is delivered; and a reporting element addressing outcomes. Links to the taxonomy are obvious here. Definitions should be drafted such that they can be mapped onto the fund environment and thought should be given to all three aspects, aims, process and reporting. In order to avoid greenwashing there must be some form of cost-effective verification or external assurance. This is crucial for investors and analysts. Verification will also have the effect of improving the quality of disclosed information and the process which determines what data to disclose

Permissive and not restrictive. If capital is to flow it needs to be encouraged not frustrated by artificial barriers such as overly-prescriptive definitions appearing in the criteria for receiving labels. Throughout the process the approach should be NOT to say that "X is and can only be Y", where X is an aim, process or outcome. Instead language such as "X may encompass, for the sake of example, A, B or C but other approaches are welcome so long as their goals are congruent".

Sustainable Infrastructure Europe

UKSIF does not support the creation of Sustainable Infrastructure Europe as a market or venue to match capital and capital users. Market forces will fill the need once the necessary fiscal, regulatory, environmental and political changes have been made. Setting up a body before those changes will not help rapid growth. However, the majority of our members are keen to see greater emphasis on sustainability in infrastructure and would support an element of Commission activity if it addressed the need to make the necessary changes in the Union to accelerate activity. There is huge potential for infrastructure and the European Investment Advisory Hub (EIAH) to contribute to an investible EU 2050 climate strategy. The current roadmap suggests that by 2050 the EU should cut its emissions by 80% compared with 1990 levels. Freeing and easing the infrastructure market could play a significant role in the process.

Infrastructure represents an opportunity to create a framework whereby the business case for making money from sustainable operations is demonstrated beyond reasonable doubt. In addition the HLEG will need to consider ways in which it can boost long-term investment in these projects. Mismatched time horizons across the investment and lending chain can have a detrimental effect on end-beneficiaries with long-term investment horizons (or rather, these beneficiaries are currently unable to capitalise on the illiquidity premium associated with such investments).

Short-termism in finance and the 'mismatch of time horizons'

Policy makers must recognise and emphasise the importance of long-term investment and act to ensure it is properly considered by all actors in the investment chain. Short-term thinking is inefficient, detrimental and has been a key factor in the loss of trust by the public of the financial services sector throughout Europe.

We think the mismatch of time horizons is evident throughout finance. In the retail market emphasis is on relatively recent performance, whilst many institutional investors have 3-5 year cycles of asset allocation and manager review. Our perception is that even long-term investors e.g. some insurance firms, face a regulatory environment which through capital adequacy regulation does not allow them to trap the illiquidity premium available to them. We think a call from the HLEG for politicians and regulators to look at Basel III, Solvency II and the application of fiduciary duty across markets would further the debate on these important areas. UKSIF would support measures to remove the necessity of quarterly reporting by companies.

Key levers to align the investment and analyst community with long-term sustainability

Levers are available at many points in the various finance value chains:

Pension funds. PFs and their managers should report on their approach to sustainability challenges and their approach to stewardship. These necessary levers may be regulatory, best practice guidance or legislation.

Insurance companies. Insurers should not only report on their assets, they should outline their assessment of the liability risks they face. In insurance the levers will be primarily regulatory.

Banks. Bank reporting should show how banks assess the risks to which their assets are exposed and how the "back" book will be future-proofed. Timescales should be given. The levers will be a mixture of regulatory, accounting and perhaps national legislation.

Stock exchanges. We would encourage the introduction of more stringent disclosure requirements ahead of listing and on an ongoing basis.

Benchmarks. The HLEG plans to look at benchmarks in more detail. Our members enthusiastically support this.

Data. All of the levers will need data- data of new kinds, assessed and presented in different ways. UKSIF members were disappointed that the interim report did not recognise the great contribution to the resolution of many of the issues we face which good data from data providers and brokers can offer. The lack of reference to them in the section on credit ratings was a serious omission which we hope will be corrected in the final report.

Fiduciary duty.

Clarifying fiduciary duty at EU-level is essential. In the UK there remains confusion over which factors can be taken into account which has presented an obstacle to long-term sustainable investment. There is a belief held by many that fiduciary duty requires maximisation of short-term returns which is clearly to the detriment of sustainable investment. Clarification that fiduciary duty requires the incorporation of all financially material factors, including those arising from ESG, and permits the incorporation of non-financial factors would be a welcome step in the right direction. We would welcome the publication of guidance on fiduciary duties by the EU in relation to the IORPs II Directive. The EU must start to use appropriate language in its communications: The *Non*-Financial Reporting Directive is welcome, but it deals with reporting of ESG and other sustainability information precisely because that information is financially material. By continuing to use the misnomer “non-financial” the EU perpetuates the myth that these factors do not impact the value of an investment and can therefore be ignored.

In short, the levers exist, what has been lacking is the will to pull them. We hope HLEG will help change that.

Strong and visible pipeline of sustainable investment projects ready for investment at scale

UKSIF members back proposals to include capital-raising plans in National Energy and Climate Plans (NECPs). Ensuring investors are aware of the role private finance is expected to play in delivering sustainability objectives is an important step forward and we agree this would help to pave the way for an investible EU 2050 climate strategy.

Encouraging credit rating agencies to consider ESG long-term risk factors

There is no need for an EU credit rating agency, market alternatives exist. Our members support option three in the questionnaire, to “require all credit rating agencies to include ESG factors as part of their rating”.

Improving ratings will play a part in effecting change, but we need to make the investors change as well. In that context reporting obligations should be considered and the HLEG should recognise the considerable amount of data and expertise in this area lying with data providers of all types as well as brokers and banks.

Involve banks more strongly on sustainability

As the largest source of external finance for the companies it is right that banks are at the forefront of the transition to a low-carbon, sustainable economy. More can be done, however, to assist banks reach their potential in contributing to this transition. As the report identifies, one major obstacle in recent years has been the trend of some European governments to withdraw schemes supporting green investment during the lifetime of transactions which are often only viable with subsidies. This was the experience in the UK in 2015 when the Government announced a “bonfire” of such schemes which included scrapping support for onshore wind, solar and biomass energy production, ending the “green deal” and removing the exemption from the carbon levy for renewable energy generation. At an UKSIF-convened meeting between UKSIF’s bank members and the then Department of Energy and Climate Change the point was made strongly that such unexpected moves by the Government was extremely unhelpful. Many UK banks now have their own sustainable or green lending targets and the cancellation of these schemes was having an extremely detrimental impact on the banks’ ability to meet their own ambitions.

The ability of the HLEG to impact the energy policies of national government may be limited unless it is backed by the Commission, however it should use its clout to influence the regulatory framework which governs the international banking system. UKSIF members believe there is merit in revisiting all three pillars of Basel III, although we are clear this will not be an easy task given the international nature of the regulatory framework.

Specifically, UKSIF members agree that the minimum capital requirements for asset classes including green bonds and green loans should be adjusted. This would represent an important policy signal to encourage banks to invest in green infrastructure. More work will be necessary to determine which assets are green or sustainable and this will be covered in the work on taxonomy, but also to collect data to gain more information on these assets' risk profiles.

UKSIF fully supports the proposal to strengthen both Pillar II and III:

- Stress tests by central banks should be extended to risks relating to sustainability. In the UK the Bank of England has undertaken work on the financial implications of climate-related risks which takes a forward-looking approach with a view towards early intervention. The Governor of the Bank of England has also discussed the benefits of using stress-tests to profile the impact of climate change. This commitment to better understanding the effects of climate change should be emulated by other central banks and prudential regulators throughout the EU and work should also begin at the European level.
- We support measures to improve the transparency and disclosures by banks of sustainability factors and how these influence their risk profile and the systems risks they generate for the wider financial system.

Involving insurers more strongly on sustainability

UKSIF believes reform of Solvency II could have a positive impact on redirecting capital flows to more sustainable projects. While the arguments and mechanisms by which this can be achieved are similar to those outlined in the previous question relating to banks, reform of Solvency II is patently more achievable given it is an EU Directive. In the UK we have heard that some UKSIF members have faced problems investing in long-term, illiquid products due to the capital adequacy requirements introduced by the Directive. The amended regulation was an improvement – qualified infrastructure investments incentivise insurers to invest in long-term infrastructure projects. We would encourage the HLEG to investigate how the valuation of assets and liabilities can be reformed to ensure long-term investment is not discouraged. Specifically, we envisage a further recalibration of the rules to incentivise investment in green or sustainable projects.

Mobilising private capital for social dimensions of sustainable development

The social dimension is an incredibly important aspect of these discussions, but UKSIF members were concerned that it appears to come as an afterthought. Climate risk is rightly considered to be a key and pressing issue, but the HLEG should not lose sight of this opportunity to boost thinking around social factors. The business case to consider such issues may change more frequently than with issues relating to environmental factors or corporate governance and it is also probably the least understood of the E, S and G factors. Linked to this is the fact that it is currently far easier to report in terms of a company's environmental impact. Reporting on social issues is not as advanced and the HLEG should consider ways in which it can assist companies and investors to improve.

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We would urge the HLEG to review the high-level recommendations set out by the G8 Global Social Impact Steering Group which makes various policy recommendations for governments. These include that the fiduciary duties of trustees should be clarified to allow them to consider non-financial as well as financial factors in investment – a recommendation which receives our full support. One UKSIF member made the point that the focus here is solely with the financial services sector. For genuine social development meaningful reform needs to take place in various sectors.

I hope our views are clear. If you have any questions or require further information please do not hesitate to contact me via fergus.moffatt@uksif.org.

Yours sincerely,

Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)