

**The Ambition and Challenges of Sustainable Finance:
Presentation of the Interim Report**
by Christian Thimann,
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Dear Vice-President Dombrovskis,

Dear Vice-President Katainen,

Dear Ambassador Jagger,

Dear Members of the European Parliament,

Dear Colleagues, dear Ladies and Gentlemen,

Introduction

We all recognise that sustainability must be the model for Europe's future development. Ambassador Jagger's remarks have made clear that this desire is widely and deeply held among the citizens of the European Union.

What is perhaps less widely understood is that finance is an essential lever for achieving our ambitious collective goals for economic prosperity, social inclusion and environmental regeneration. Europe needs a financial system that promotes sustainable economic development rather than boom and bust; sustainable social development rather than inequality and exclusion; and sustainable environmental development rather than damaging the endowments of nature.

The EU has been leading on the agenda for making the transition to a sustainable European economy and a sustainable financial system. The challenge now is to develop a clear strategy that unifies this ambition with one of the EU's key achievements in terms of financial policy and regulation, and which funds the path towards a low-carbon, resource-efficient and environmentally protective economy.

This is where the High-Level Group on Sustainable Finance, which I have the honour of chairing, comes into play. It is my pleasure today to present to you the Group's Interim Report and our preliminary findings and recommendations.

Acknowledgements

I would like to begin with some important acknowledgments. The first is to the European Commission for its political leadership and support. Vice-President Valdis Dombrovskis, Vice-President Jyrki

Katainen and Director General Olivier Guersent deserve deep respect for having identified the challenge of a new model of sustainability and seeing the scope for finance to make an important contribution.

There have been many previous initiatives on sustainable finance. The unique feature of this Group is that it is working with the EU's main financial regulator: the European Commission is providing the Secretariat to the Group and, though the Group works independently, supports the Group through its expertise.

The Group gratefully acknowledges the outstanding support we have received from the four core members of the Secretariat and the twelve other experts from the Directorate General Financial Stability, Financial Services and Capital Markets Union. Without this remarkable support, the Group could not have travelled so far at such speed. The Group is also grateful for support from the Directorates General Climate Action, Economic and Financial Affairs, Energy, Environment, and Justice and Consumers.

The Group is grateful to our Observers who have not simply surveyed the group but made many valuable observations during the meetings; they have been most active in contributing their expertise and advice to the Group's proceedings and report. The Group is also grateful to our Sherpas and team members for untiring support.

The High-Level Expert Group on Sustainable Finance has not started from scratch and we have not worked in isolation. We have built our considerations on a broad range of work that has been done over many years on this area, and it has also taken up the invitation to contact a large number of practitioners, stakeholders and other experts—many of whom are here today. Many of you are in this room. A big thank you to all of you. If we could get as far as we did in just a few months, it is because we are standing on the shoulders of giants.

The scope of sustainable finance

Sustainable finance is about two imperatives: the first imperative is to improve the contribution of finance to sustainable and inclusive growth, funding in particular society's long-term needs for innovation and infrastructure, and accelerating the shift to a resource-efficient and low-carbon economy.

The second imperative is to strengthen financial stability and pricing in financial markets, notably by improving the assessment and management of long-term material risks and intangible drivers of value creation – including those related to environmental, social and governance (ESG) factors.

In short, sustainable finance means ‘better development’ and ‘better finance’ – growth that is sustainable in each of its economic, social and environmental dimensions; and a financial system that is focused on the longer term as well as material ESG factors.

Interim Report

Our Interim Report outlines key areas where European policy-makers could promote better alignment of financial practices with sustainable policy objectives.

It begins with a vision for a sustainable financial system, key barriers that will need to be addressed to achieve that objective and the critical factors for success.

The Report then provides detailed analysis of ways of integrating sustainability into the EU’s regulatory and financial policy framework, covering issues such as disclosure, accounting, fiduciary duty, corporate reporting and benchmarks.

It examines the roles in the financial system of market participants (banks, insurance companies, pension funds and asset managers) and market facilitators (including credit rating agencies and stock exchanges).

And it explores measures that can mobilise more capital flows towards sustainability, in terms of both public and private finance. It also addresses the issue of sustainability taxonomies, standards and labels.

The Interim Report has early recommendations and policy areas for consideration in phase II.

Vision of a sustainable financial system

A financial system that serves sustainable development of the EU is one that:

1. Is productive, financing job creation, education, innovation, infrastructures and other real economic needs
2. Considers the full value of financial assets
3. Demonstrates alignment between the preferences of its users and the outcomes along the lending and investment chain
4. Takes a long-term perspective, overcoming the ‘tragedy of the horizon’
5. Is resilient against a wide range of shocks

Sustainability also challenges a number of our established wisdoms. The view that that liquidity is generally better than a long-term illiquid exposure is challenged because the latter is likely to create more social value. The view that markets produce the best prices is challenged when we see that many investment and trading decisions have time horizons well below the sustainability or impact threshold. And the view that efficiency is 'king' is challenged if financial costs and financial evaluation exclude many factors to which wider society is attached. All this makes sustainability a comprehensive exercise in re-evaluation of what matters to us collectively.

Early recommendations

Given the emerging global policy context and the strong policy momentum within the EU on sustainability issues, the HLEG submits a set of early recommendations in the spirit of highlighting early policy orientations. These may be further elaborated by the Group in the months to come.

Recommendation 1: A classification system for sustainable assets

The first recommendation is to establish an EU classification of sustainable projects and financial assets. Such a classification should be based on broadly acceptable definitions of 'sustainable'. The classification system should serve to identify projects contributing to EU environmental policy goals including climate change mitigation and adaptation, biodiversity loss, natural resource depletion, pollution prevention and control. Ingrid and Philippe will later dwell on these issues.

Recommendation 2: A European standard and label for green bonds and other sustainable assets, and labels for sustainable funds

The development of an EU standard and label for green bonds and other sustainable assets is now within reach, and the Commission's support can ensure that an EU standard will be fully developed. The EU green bond market has yet to reach its full potential and can serve as a basis for other sustainable asset classes. To spur market growth, the EU should consider introducing official European green bonds standards. Given the enormous mobilisation of capital expected, the tool of a green bond standard should be implemented.

Recommendation 3: Fiduciary duty that encompasses sustainability

The time has come to establish a single set of principles of fiduciary duty and related concepts of loyalty and prudence, building on progress recently achieved in legislation such as IORP II. Regulatory authorities need to make clear to all involved in the investment and lending chain that the consideration and management of ESG risks is integral to fulfilling fiduciary duty, acting loyally to

beneficiaries and operating in a prudent manner. The misinterpretation of fiduciary duty as requiring a focus solely on maximising short-term financial returns is still common. The problem is a lack of appropriate standards in some instances, as well as a lack of clarity of some existing rules. The single set of principles can feed into the respective relevant laws according to the specificities of market participants.

Recommendation 4: Disclosures for sustainability

Disclosures by non-financial firms and financial institutions of material information on sustainability issues should be further strengthened. This information is critical to management, investors, employees, lenders, supervisors and other stakeholders. The recent TCFD recommendations should be integrated in a way that advances EU leadership on these areas, while providing legal certainty and maintaining a level playing field globally. The feedback and concerns from the firms regarding reporting burden and legal risks, which we have heard once more recently, should be heard.

Recommendation 5: A sustainability test in financial legislation

Sustainability has not yet been integrated properly into all the relevant EU financial legislation. It would be useful to develop a 'sustainability test' to ensure that sustainability is embedded across all future EU financial regulations and policies. This means that impact assessments of proposed legislation and policies include 'a description of the environmental, social and economic impacts and an explicit statement if any of these are not considered significant' in order to guide legislative and policy options. Also the consideration whether and how the proposed regulation favours a long-term orientation of finance should be explored.

Recommendation 6: Create 'Sustainable Infrastructure Europe'

Europe needs to build new infrastructure and improve existing infrastructure for sustainable development. There is private capital ready to fund it, the Juncker plan is an excellent basis, and yet a full project pipeline is still to be developed. A dedicated advisory and 'match-making' facility between public authorities and private investors would appear useful to boost Europe's ambitious infrastructure plans, especially in the area of sustainability investments. The EU could create 'Sustainable Infrastructure Europe', a dedicated organisation responsible for advising municipalities and other public authorities on structuring and developing infrastructure projects and matching them with investors, with a particular attention to sustainability investments. Today, many local mayors throughout the EU do not know to whom to turn in Europe for advice on how to develop and structure infrastructure projects in a way that is attuned to private investors. The current European Investment

Advisory Hub at the EIB (EIB) in Luxembourg is small compared with the number of potential investment projects across the EU and it is remote from many parts of Europe. The Group will further develop this recommendation and is soliciting feedback. Linked to that could be a way to limit political and regulatory risk – the risk that once a project is developed, financial conditions change. This is one of the biggest headaches for investors in projects that, by their very nature, are illiquid.

Recommendation 7: Position the European supervisory agencies (ESAs) on sustainability

The current review of the ESA operations provides an excellent opportunity to enhance their role in assessing sustainability risks in order to secure the long-term stability of Europe's financial sector, even without changing their current mandate.

Recommendation 8: Accounting standards for energy efficiency

Eurostat's interpretation of public sector accounting standards on energy efficiency investments needs to be improved. This narrow interpretation of public sector accounting standards on government budgeting for energy efficiency is one of the main drivers of under-investment in energy efficiency, and correcting this interpretation is one of the quick-wins mobilising more capital in this crucial area.

Policy areas for further discussion

In addition to the policy recommendations described above, the HLEG is working on a number of other policy areas that require further discussion and analysis. Taking account of stakeholder feedback, additional recommendations will be considered in the final report on a wide range of issues, including those outlined below.

1. Long-term policy signals to the private sector
2. Governance of firms and financial institutions
3. Integrating sustainability in ratings
4. Frequency of financial reporting
5. Accounting frameworks
6. Benchmarks
7. Banking
8. Insurance companies
9. Stock exchanges and green financial centres
10. A strong pipeline of sustainable projects for investment
11. Involvement of society in sustainable finance issues
12. Social dimensions

This is a long list. But it is long for the very good reason that the EU's ambitious objectives for sustainability, including addressing far-reaching investment needs, will not be met simply by adding a green component to the system. Sustainable finance requires a comprehensive review of the structure and functioning of the whole system. Magnus and Paul will discuss some of these issues on more detail later, but cutting across them are two big challenges.

The first big challenge is how to foster longer-term orientation in finance and mobilise more capital for productive long-term investment. This Report explores ways to attenuate impatience in finance and avoid decision-making that is based on too short time horizons, in particular regarding investments.

In particular, the Report highlights a few key areas of adjustment in the regulation of banks, insurance companies, and even accounting rules. For example, while there is broad support for the new prudential rules in banking, the question arises whether in some aspects of long-term lending, project lending and specialised lending, the framework would benefit from adjustments: brown-penalising and green-supportive factors are aspects highlighted for discussion. In insurance, there is broad support for Solvency II, but the question arises whether the framework has an adverse impact on long-term investments and products, and whether pro-cyclicality can be attenuated. In accounting, the question arises whether the focus on current market prices and the volatility that this creates unduly restricts long-term and equity investment.

The second big challenge is to integrate ESG factors into financial decision-making: the Report examines key elements across the investment and lending chain. I have already mentioned fiduciary duty. Open issues for discussion include credit ratings and key benchmark indices in stock and bond markets. With credit ratings, the integration of sustainability issues is still in its early stages and a key question is whether Europe could make a much stronger contribution here. With market benchmarks, there are concerns that they have a powerful influence on capital flows but they are not as forward-looking as certain indices with sustainability adjustments, which are as yet little used in markets. Again, this is an issue for further analysis and stakeholder feedback.

Conclusion

Our Interim Report is aimed at readers in Europe and beyond, who are concerned about issues of sustainability, financial markets and the wider challenges for society. As I said earlier, sustainable finance cannot be achieved with one stroke of a pen. But neither does it require rewriting the whole

system of financial regulation. Rather, it means identifying the key areas where adjustments are needed and developing specific and targeted proposals for change. This is our approach.

We hope that our Report will help to stimulate debate on sustainable finance and create the basis for engagement by a wide range of stakeholders today and over the coming months to inform the Group's final report due in December. The Commission is today opening a public consultation on the Report, which will run until September. As you will see, the questions are open – and we are sincerely interested in your insights, guidance and advice on how to move forward.

As I said earlier, the EU has been leading on the agenda for making the transition to a sustainable European economy. I believe that we are all convinced that in the aftermath of the financial and sovereign debt crises, sustainable finance provides the best opportunity for the EU to push that agenda further: to reorient the financial system from short-term stabilisation to long-term impact for the benefit of all Europe's citizens.