European Fund and Asset Management Association

EU Strategy on Sustainable Finance
Views from a European asset management perspective

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rue Montoyer 47, B-1000 Bruxelles
☎ +32 2 513 39 69 • Fax +32 2 513 26 43 • e-mail : info@efama.org • www.efama.org • VAT Nr BE 0446.651.445

General remarks

EFAMA is supportive of the European Commission High Level Expert Group's ('HLEG') aim to develop an EU strategy on sustainable finance. We believe that such an EU policy framework could help stimulate and educate in the field of responsible investment and sustainable finance. As sustainable finance is a growing, competitive and innovative field involving cross-sector disciplines, we would welcome an EU policy framework focused on market-driven developments.

Global framework

In this context, a future EU strategy on sustainable finance policy objectives needs to be aligned with global initiatives such as the COP21 targets and the Sustainable Development Goals both of which will require a shift in current business models to accelerate investments in sustainable solutions.

Role of asset managers

Asset managers manage the financial assets of asset owners with the view of maximising returns over the long-term. The clients of asset managers vary from individuals to sovereigns to endowments, charities, pension funds and insurance companies. Individuals, and institutions who invest on their behalf, entrust their money to asset managers who seek to achieve their financial goals by investing in capital markets, companies and infrastructure such as transport links and hospitals (list non-exhaustive). Asset managers also help to fund governments and are among the biggest investors, on behalf of their clients, in government bonds. This helps to create jobs, support a stronger economy and provide infrastructure.

Asset managers' fiduciary business model dictates them to invest in capital markets and projects based on their clients', individual and institutional asset owners, investment guidelines and profile, best long-term interest. As such, asset managers seek to integrate the environmental, social and governance ('ESG') factors, in their investment process – to ensure they best protect their clients' investments over the long-term. Many asset owners feel a responsibility to take part in sustainability matters by being more inquisitive about the ESG profile and impact of their investments, or even by being more selective in their investments. As a result, their asset managers follow both asset owners' goals, values and ESG objectives to execute their investment strategy. To do so, data made available by investee companies is paramount.

In listening to asset owner clients and providing them with investment solutions to achieve their financial and impact (if they have any) objectives, the asset management industry contributes to a more sustainable economy by:

- Providing asset owners with the competence to integrate ESG in the investment process
- Reporting to clients, including on ESG related risks and opportunities
- Engaging with companies in the portfolios of their clients to understand their management of ESG challenges

Balance of E, S and G pillars

A future EU strategy on sustainable finance agenda should focus on a balance of the three E, S and G pillars. We would strongly emphasize the equal importance of social challenges such as labour conditions, human rights, the development of successful governance frameworks, as well as environmental issues like water risk, arable land, natural habitat to climate risk in pursuing a comprehensive, complementary and effective approach to sustainable finance. We believe that the ‘G’ is the primary driver to achieve ‘E’ and ‘S’ objectives. Active ownership or engagement has many advantages in driving corporate responsibility on all these issues forward.

1. Promoting institutional demand and fiduciary duty[1]

Asset managers are legally required to act in the best interests of their clients. In the sustainability context, EFAMA believes that asset managers have a duty to integrate ESG considerations into the investment process, when these considerations are expected to have a financial impact on the performance either short or longer term. Over the past decade, the view has increasingly spread that many responsible investment considerations are material in terms of pricing and the risk profile of the investment.

EFAMA believes the concept of fiduciary duty in Europe is aligned with responsible investment. While we welcome the move in the revision of the Shareholder Rights Directive and IORP II to encourage both demand of ESG and disclosure of ESG criteria in the investment decision-making in line with clients’ goals, we believe it would be inappropriate to seek to codify fiduciary duty, an Anglo-Saxon case law concept, into public law EU Directives.

As well as being a risk management tool for asset managers, ESG specific analysis will hinge on client demand. Building on SRD II and IORP II, asset owners need to be clear in identifying their ESG wishes and strategies and setting their expectations as part of mandates or choosing ESG products. Ensuring that the adequate framework is in place for good quality disclosure of material ESG information by asset managers to their clients, in line with their fiduciary duty, will also be important, and in this regard we believe the provisions of SRD II are sufficient.

EFAMA Recommendations

- EFAMA believes the concept of fiduciary duty in Europe is **aligned with responsible investment** and we do not believe that any legislation in this regard is the way forward.

- The notion of fiduciary duty does not exclude sustainability considerations. Asset managers have a fiduciary duty to integrate ESG considerations into the investment process, when these considerations are **financially relevant, in other words: material**.

- As intermediaries in the investment chain, asset managers’ approach to ESG and related products rely on **clients’ own goals, values and ESG objectives**. Asset owners need to be clear in identifying their ESG ambitions and strategies and setting their expectations as part of mandates or choosing ESG products.

[1] For further information on our views on fiduciary duty, please refer to the EFAMA Responsible Investment Report (2016), p12

2. Time horizons: the long-term / short-term debate

Reducing the pressures of short-term performance objectives and working instead to invest in long-term growth remains an issue of paramount importance for asset managers and their clients, most of whom are saving for retirement and other long-term goals, and the global economy. However the picture is complex: each asset owner has their own investment objective and time horizon and asset managers who manage institutional mandates or investment funds apply different investment strategies linked to different time horizons in order to meet their clients' needs and expectations.

Barriers to long-termism – an asset manager's perspective

- Sectoral regulation for asset managers is often focused on the short-term:
  - MiFID II is, to a certain extent, focused on short-term decision-making. The annual, quarterly and ad hoc reporting requirements of asset managers to clients in MiFID II are one such example. Even though this is a barrier to long-termism, we recognise that such reporting is important for many clients. It is part of a set of transparency rules which is much valued both by the asset management industry and its clients.
  - The daily pricing for some defined contribution pension products is a barrier to moving towards a more sustainable financial system, which requires investment in illiquid assets. In situations where the participant in the pension product is not allowed to liquidate their pension assets, before a certain date, daily pricing is probably unnecessary.

- Nature of investment management agreements: there is a culture in the institutional market for strategic reviews of investment management agreements to take place 3-5 years, with quarterly and annual evaluations and reporting, meaning asset managers often have to prove themselves on short-term results.

- Lack of adequate pension returns for individuals: the long-term investment policy of pension savings should be promoted to help savers benefit from illiquidity risk premium. EFAMA believes that the creation of a Pan-European personal pension ('PEPP') with specific investment rules and a retirement objective can favour adequate pension outcomes for EU citizens, while channelling capital to long-term investments in business and infrastructure in Europe. EFAMA believes that pre-enrolment disclosure of the PEPP should include, if applicable, reference to any specific ESG objectives targeted by the PEPP investment options.

- Need for long-term outlook by companies:

  A company's management of all of its risks, including ESG, is from an investor and asset management perspective, an indication of quality of management and long-term value creation. In the execution of their clients' investment strategies, asset managers will establish whether companies engage in practices which may undermine their long-term business success thereby impacting the value of client's assets on the long-term.

  In terms of market asks:

  - Companies need to be transparent about their growth plans to allow shareholders evaluate progress of their long-term growth strategy such as for example information on how a company is navigating the competitive landscape, how it is innovating, how it is adapting to technological disruption or geopolitical events, where it is investing and how it is developing its talent. Annual shareholder letters and other communications to shareholders are too often retrospective. Shareholders would welcome dialogue on these strategic issues.

- As part of this effort, companies should work to develop financial metrics, suitable for each company and industry, supporting a framework for long-term growth. Components of long-term compensation should be linked to these metrics and we expect the implementation of SRD II to help in this regard.

- The need for quarterly reporting is contrary to the long-term approach needed. While we believe companies should still report quarterly results – "long-termism" should not be a substitute for transparency – CEOs need to show progress against strategic plans longer-term.

In terms of focus for the High-Level Expert Group, there would be an opportunity for the EU to encourage uptake of recommendations put forward the FSB's Task Force on Climate-related Financial Disclosures. Such work could be expanded beyond climate change to cover all areas of E, S and G issues. However, the FSB's supplemental guidance is not specific when it comes to metrics beyond carbon footprint (Scope 1-3). It is our view that all sectors need (sector-specific) comparable metrics. To enable investors make effective investment decisions based on ESG data, the information needs to be material, forward-looking and reported in a standardised format.

Market benchmarks and sustainability

There would be an opportunity for the HLEG to explore why sustainability outcome-oriented benchmarks have not had more take-up. We would emphasize the importance of a market-based approach to this question.

In terms of whether current benchmarks used by asset managers need to be phased out in favour of more sustainable benchmarks, the reality is that many benchmark providers also produce sustainability benchmarks, such as the FTSE4Good. And anyone who wants a benchmark that differs from existing ones can pay for a benchmark provider to do so.

Reliable benchmarks are those which accurately reflect the market. Benchmarks cannot change investment strategies, rather they are used to measure the quality of execution of such strategies.

EFAMA recommendations

From an asset management perspective, there are a **number of obstacles to long-termism** such as sectoral regulation, the nature of investment management agreements and lack of adequate pension returns. We are encouraged by the recommendations of the FSB's Task Force on Climate-related Financial Disclosures which will enhance long-term outlook by companies and there is certainly an opportunity for the EU to encourage uptake of these recommendations, which will build on the Non-Financial Reporting Directive.

In terms of **market benchmarks and sustainability**, there is an opportunity for the HLEG to explore why sustainability outcome-oriented benchmarks have not had more take-up, however we would strongly emphasize the importance of a market-based approach to this question.

3. Transparency

In EFAMA's view, transparency is one of the tools with great potential to reinforce sustainable finance. Standardisation at EU level should occur on corporate reporting, and on institutional investor reporting. However, standardisation of products in general, but especially so in responsible investing, could, in our view, stifle innovation and market development.

Standardisation of reporting

By companies

- We welcome the Non-Financial Reporting Directive which will encourage companies to disclose relevant, material ESG information as well as the European Commission's recently published Guidelines on the disclosure of environmental or social information, which will help companies disclose in a consistent and more comparable manner. Assessing the take-up and the rolling out of these initiatives over the next few years will be essential.

- From an asset manager's perspective, the drive towards standardisation of disclosure frameworks is key for ensuring access to reliable and accurate reporting on ESG issues by companies. From an asset manager's operational point of view, this will facilitate the investment decision-making process but also enable asset managers quantify the impact of their investments on their portfolios. Continued development and harmonisation of disclosure practice globally is therefore of utmost importance.

- To foster further capital allocation to sustainability, the EU could support the streamlining / harmonisation of data such as:

  - CO2 emissions by investee companies; and in terms of business risk the embedded CO2 emissions in products sold by companies in certain industry sectors (e.g. coal, liquid fuels, gas etc.)

  - Whether or not ESG is integrated into the remuneration rules of investee companies;

  - Unforeseen employee absence as percentage of workable days;

  - Turnover of employees;

  - Independence of the board (number of independent board members, i.e. not being part or related to management, no conflict of interest);

  - Diversity of the Executive Board and of the Supervisory Board of the company;

  - Diversity of the workforce;

  - Whether or not the company has signed the Global Compact;

  - Supply chain management;

  - Report on relationships with key stakeholders such as employees.

By asset owners and asset managers

In principle, we are supportive of carbon reporting for institutional investors. However, the key from an operational perspective remains both proportionality and a harmonised methodology for doing so. As explained above, a prerequisite for doing so will be reliable data from companies.

ESG Labels and ratings[2]

In any discussion of the role of the EU in developing and promoting EU labels and SRI products, EFAMA believes the following set of principles are fundamental in the elaboration of ESG ratings and labels for investment funds and asset managers:

- **Initiative for the rating/label:** Initiative should be with the fund/asset manager, not the labelling or rating organisation, as this ensures that only funds are ESG-labelled where relevant.

- **Comparability**: In the interest of comparability for consumers, achieving one standardised or harmonised European way of labelling or rating funds could be a mid-term goal. Common definitions and guidelines at EU level would be a first step in the right direction.

- **Process-based approach**: EFAMA believes responsible investment should be defined on a process basis, not on the basis of (outcomes of) a certain set of moral or ethical values.

- **All asset classes and all dimensions of ESG investing should be covered**: To enable comparability for investors, an ESG rating or label should generally be suitable for every fund.

- **ESG investment funds and responsible investment assets under management need to be distinguished**: Asset managers may integrate ESG factors in their investment process without applying a specific ESG strategy at the fund level. A sustainability rating should distinguish between responsible investment assets under management and ESG investment funds.

- **Objective evaluation**: A label denotes an objective evaluation by a third party (i.e. the label provider) of the ESG process that is followed by the fund and/or its manager. Rating providers should use different varied sources to properly assess the fund's assets, or else be transparent in relation to the set of ethics/morals the rating is based on.

- **Take ESG investment strategies into account**: Given the linkages between environmental, social and governance challenges, a sustainability rating or label should take all ESG related questions into account.

- **Exclude conventional scoring aspects**: ESG ratings and labels will only be able to provide investors with meaningful comparability regarding responsible investing if the rating or label focuses solely on these aspects. Conventional considerations such as costs or performance should be covered separately in conventional ratings and labels.

- **Transparency**: Providers should disclose their methodology. Where a holdings-based approach is used, it should be possible to look through the providers' assessment of funds' holdings to

[2] EFAMA has written an opinion on ESG ratings and labels. This section is a summary of the general principles which we believe should be taken into account by ratings/labels providers in the elaboration of ESG ratings and labels for investment funds and asset managers

understand the rating. In other words, in a holdings-based approach the set of ethics/morals which lead to the scoring of individual holdings should be given.

EFAMA Recommendations

- Further **standardisation of disclosure frameworks** is essential to ensure asset managers' access to reliable and accurate reporting on ESG issues by companies. From an asset manager's operational point of view, this will facilitate the investment decision-making process but also enable asset managers quantify the impact of their investments on their portfolios.

- In principle, we are supportive of **carbon reporting for institutional investors**. However, any policy initiative in this regard needs to focus on proportionality and a harmonised methodology.

- In any discussion on a role for the EU in developing a **sustainable finance label for sustainable finance products,** EFAMA would encourage policymakers to refer to our general principles on ESG ratings and labels which lays out our vision on the matter.

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