EUROPEAN COMMISSION

Brussels, 24.5.2018
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REGULATORY SCRUTINY BOARD OPINION

Proposal for a Regulation of the European parliament and of the Council on the establishment of a framework to facilitate sustainable investment

Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341

Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks

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EUROPEAN COMMISSION
Regulatory Scrutiny Board

Brussels,
Ares(2018)

Opinion

Title: Impact Assessment / Sustainable Finance Initiative

(version of 8 May 2018)*

Overall 3rd opinion: POSITIVE WITH RESERVATIONS

(A) Context

In March 2018, the Commission adopted an EU Action Plan on Financing Sustainable Growth. The Commission has estimated that achieving EU climate and energy sustainability targets by 2030 will require additional annual investments of EUR 180 billion. Much of this would reportedly need to come from the private sector.

This report draws on findings of a High Level Expert Group (HLEG) on sustainable finance. It considers parts of the EU Action Plan to reorient private capital flows towards sustainable investments. In particular, it considers requiring asset managers and others to consider Environmental, Social and Governance (ESG) factors in their decisions. This might improve management of related risks. A new classification system or taxonomy at EU level would lead to a common understanding of what is 'green' or 'sustainable.' Such a taxonomy could also lead to better benchmarks for sustainability.

(B) Main considerations

The Board notes that the revised report proposes a ‘phased approach’ to sustainable finance and locks in a path with a precise timing. This approach has several unknowns and defers many elements that could cause significant burdens. It foreshadows additional impact assessments before full rollout.

Compared to the previous versions, the resubmitted report presents additional information, acknowledges risks and adds several safeguards. Taken together, these modifications address the main concerns of the Board. However, the report still contains significant shortcomings that need to be addressed. As a result, the Board expresses reservations and gives a positive opinion only on the understanding that the report shall be adjusted in order to integrate the Board's recommendations on the following key aspects:

(1) Aspects of the taxonomy and requirements to report on ESG factors remain unclear.

(2) The report contains inconsistencies and does not adequately organise additional cost data to support a comparison of options.

* Note that this opinion concerns a draft impact assessment report which may differ from the one adopted.

(C) Further considerations and adjustment requirements

(1) On a number of aspects, the report still needs to clarify how ESG reporting requirements would work. The report now explains that if no ESG factors are relevant for future financial returns, asset managers will not need to do anything differently. The practical implications of asset managers' ESG reporting requirements are still unclear. The report should clarify that the transparency for end-investors will go only as far as a certain ESG factor is likely to affect financial returns of a given product or portfolio. The transparency requirement would thus not necessarily satisfy an end-investor's need to identify 'ethical investments'. The report now argues that most information needed for ESG requirements is already available in the market. However, it also argues that practical implications will depend on the specifics of products, strategies, etc. Hence, the report should address the likelihood that information for the ESG duties will not be available in the market. The report should also explain why asset managers in banks and credit institutions are included in the scope of ESG reporting requirements, but excluded from the scope of the secondary disclosure requirement (see 6.1.2 'scope').

The report should be more precise on how the notions of 'do no harm' and 'contributing substantially to sustainability' will be made operational. It is also not clear if some of these notions will be defined at this point or left for the secondary legislation to define. To the extent that they will be defined now, the report needs to analyse possible options.

(2) The report now includes a number of safeguards (screening criteria) to be applied when developing the delegated acts. However, the issues and risks covered (competition aspects, consistency of incentives, fairness, excessive costs, greenwashing, etc.) should also be analysed and integrated into the monitoring and evaluation framework to ensure that evaluations at a later stage will examine and report on how intentions and concerns in those areas have played out in practice.

(3) The report needs additional editing to streamline the presentation. It is not clear whether some apparent inconsistencies in the text are intentional. For instance, descriptions of planned safeguards differ across sections.

(4) The report should make the cost-benefit trade-off more transparent when comparing options. It is not clear why adding disclosure requirements sometimes results in higher efficiency compared to the do-nothing baseline. It clearly adds to costs, and cost appears to be the sole component of the efficiency measure. The report aggregates benefits and costs into one 'score' for each option. But the addition of three elements on effectiveness and one on coherence against one on cost downplays the importance of costs by construction. It would be better to report benefits and costs separately, because striking the right balance is a key political decision.

The Board takes note of the presentation of the various costs and benefits associated with the preferred option of this initiative, as assessed in the report and summarised in the attached tables. The Board notes that this presentation is mainly qualitative. Important cost and benefit elements will depend on technical criteria to be developed and impact assessed at a later stage, as well as on the actual use of the taxonomy.

[Some more technical comments have been transmitted directly to the author DG.]

<u>(D) RSB scrutiny process</u> **Normally the Board would not review a report more than twice. In this case, following a request from the Commission’s political level, the Board has exceptionally agreed to review a revised version of an impact assessment that did not receive a positive Board opinion in two earlier iterations.** **The lead DG shall ensure that the report is adjusted in accordance with the recommendations of the Board prior to launching the interservice consultation.** **The attached costs and benefit tables may need to be adjusted to reflect any changes in the choice or the design of the preferred option in the final version of the report.**	
Full title	Sustainable Finance Initiative
Reference number	PLAN/2017/1954
Date of RSB meeting	Written procedure

ANNEX: Quantification tables extracted from the draft impact assessment report submitted to the Board on 08/05/2018

(N.B. The following tables present information on the costs and benefits of the initiative in question. These tables have been extracted from the draft impact assessment report submitted to the Regulatory Scrutiny Board on which the Board has given the opinion presented above. It is possible, therefore, that the content of the tables presented below are different from those in the final version of the impact assessment report published by the Commission as the draft report may have been revised in line with the Board's recommendations.)

Table 1 – Overview of benefits

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Harmonised EU framework on ESG factors integration		
Potentially enhanced risk-adjusted returns of portfolios and products. Better reflection of investors' preferences in the investment advice.	End investors: Several of the entities interviewed indicated that integrating ESG factors has a positive impact on performance, particularly over the long-term. Even if no quantitative evidence has been provided, whenever ESG factors are deemed to be drivers of portfolio risk adjusted returns over a relevant time horizon, they should be taken into account by the relevant entities in performing their duties. All risks (financial and non-financial as well) would be taken into account, to the extent that they are integral to generating financial benefits.	When ESG factors are built into in risk models, relevant investment entities are likely to adjust their portfolios and/or their investment recommendations accordingly, leading to reduction of portfolio risks related to ESG factors and potentially higher risk-adjusted portfolio returns. Including ESG factors in financial advice (suitability test) implies more options for end investors to express their preferences and require their financial advisor to adapt the investment strategy accordingly; this in turn will avoid distortions in savings allocation.
Mandatory disclosure on ESG integration and on sustainability objectives		
Reputational benefits and potential to attract new investors.	Relevant investment entities: potential reputational benefits increase the ability to attract new investors/beneficiaries[1] The magnitude of the benefit varies largely on case-by-case basis due to different size, investment focus and business model, targeted markets segments.	The disclosure will increase transparency on how asset managers and other relevant investment entities integrate ESG factors in their investment process and advisory recommendations.[2] This will translate into reputational benefits for those who integrate ESG factors, will increase competition for high standards in ESG integration and disclosure, further improving in this way ESG knowledge, ESG awareness and market transparency.
Reduced search costs for end-investors and increased transparency.	End investors: reduced search costs[3]. We can expect that there will be incentives, such as reputational benefits, for relevant investment entities to compete for high standards of ESG integration and disclosure, This competition can further positively impact search costs.	Mandatory harmonised disclosure by relevant entities will provide more granular information on ESG integration and sustainability objectives, will enable higher comparability, increases transparency towards end-investors and financial markets, providing them with the tools to take investment decisions that correspond to their sustainability preferences. The additional requirements for products/services offered/provided as pursuing sustainability objectives will further enhance transparency, reduce the risk of greenwashing and contribute to

[1] Respondents to the public consultation indicated a high potential impact of this benefit, although no quantification was provided.

[2] This may also translate into further pressure on investees to conduct more sustainable projects and cause more flows into sustainable investments.

[3] On search costs related to sustainability, Nilsson, Nordvall & Isberg (2010) observe that investors with ESG preferences dedicate more time and resources to assessing these factors than assessing financial information such as performance and the level of risk. This highlights both the relatively large magnitude of the opportunity cost as well as a potential crowding out of the assessment of financial information by the investors with ESG preferences, which could be reduced if ESG information becomes more readily available.

		the optimal allocation of their savings towards sustainability portfolios/funds. [4]
EU environmental taxonomy with high granularity		
EU common language on what are environmentally sustainable economic activities	All stakeholders:[5] Very difficult to quantify due to the intangible nature of this benefit.	EU taxonomy will allow for a more transparent understanding of what are environmentally sustainable economic activities, and therefore assist the functioning of sustainable financial markets
Serve as building block for initiatives in the domain of sustainable finance	All stakeholders: This was not quantified as the final benefits will depend on future uses of the taxonomy.[6]	A common EU language for environmentally sustainable economic activities is a first intermediate step to enable a range of targeted initiatives in the domain of sustainable finance. It also plays a key role in tracking and comparing progress made towards achieving the EU objectives on sustainable finance.
Harmonised EU minimum standards for different types of low-carbon indices		
EU minimum standards on methodology will serve as a base for development of low carbon benchmarks.	Benchmark administrators: market opportunities (difficult to estimate) from developing low carbon indices based on an EU minimum standards	Due to the minimum methodological standards, the transparency and credibility of low carbon benchmarks will increase – this may contribute to a higher demand for these benchmarks.
Cost savings on the methodology to select investees	Benchmark administrators: reduce development costs related to internal or external methodologies/ratings to select investee companies (expenses on external ESG ratings are estimated around €150 000 - 500 000 [7]).	As the new indices provide a signal for the investors about which companies are appropriate investments for their low carbon strategies, investment entities with these strategies will be able to save a part of their search costs.
Indirect benefits		
Harmonised EU framework on ESG factors integration		
Potential market opportunity due to higher visibility of ESG risk analysis and competition for high standards of integration.	Relevant investment entities: quantification varies largely on case-by-case basis due to different size, investment focus and business model; moderate to high effect expected as the mention of sustainability may serve as a behavioural nudge.	The integration of ESG preferences into the advisory process will reduce the distortions in the investment decisions of clients and in the allocation of their savings.
More sustainable corporate decisions as a	Investee companies: more sustainable operations[8] leading for example to a reduction of waste (no quantification as the benefit varies greatly on case by case basis (e.g. for power plants vs. service	Due to the requirement of integrating ESG factors, portfolio managers will be incentivised to ask for more information on ESG factors and engage with investee companies in order to reduce financially

[4] This mandatory disclosure may also, indirectly, reduce the risk of greenwashing which might result from inaccurate non-financial information reported by issuers, as companies as these companies will have a greater interest in providing accurate "sustainable-related" information.

[5] This includes public authorities , relevant investment entities, end investors and issuers.

[6] For examples of potential uses of taxonomy, please refer to Box 7 in Section 5.6.2.

[7] Stakeholders who were consulted estimated their total expenses on external ratings in the range EUR 150 000 - 500 000.

[8] There is evidence that this factor is financially material – for example, Konar & Cohen (2001) document that a 10% reduction in emissions of toxic chemicals results in a $34 million increase in market value for listed US companies.

results of greater engagement with companies by relevant investment entities.	companies).	material ESG risks, this may result in more sustainable corporate decisions that reduce waste and may reduce funding costs.
Mandatory disclosure on ESG integration and on sustainability objectives		
More informed end investors.	End investors: more information and lower search costs usually lead to better investment decisions.	End investors will be able to take informed investment decisions due to lower search costs and reduced information asymmetry on how investment entities integrate ESG factors in their processes/recommendations; especially the selection within the "sustainable and green" funds universe will be easier due to the additional disclosure requirements for these funds.
EU environmental taxonomy with high granularity		
Reduction of search costs.	End-investors: not quantified to prevent double counting with disclosure, which has a more direct effect on search costs.	By bringing about a common language on what are environmentally sustainable economic activities, the EU taxonomy will help reduce the search costs for end-investors and help them make more informed investment decisions.
EU taxonomy facilitates the integration of environmental factors in investment decisions.	Relevant investment entities: not quantified as the impact varies greatly based on the investment decisions taken by relevant entities.	Relevant investment entities would benefit from the EU taxonomy, as clarity on what are environmentally sustainable economic activities will help them pursue their environmental investment objectives.
Increase availability of data on sustainability from investee companies.	Relevant investment entities and end-investors: not quantifiable as the data will depend on the actual technical criteria developed under Level 2 of the taxonomy and on the extent to which issuers choose to provide more information.	The development of clear technical criteria which are used to identify environmentally sustainable economic activities will provide the basis for comparison of companies engaging in eligible activities. This could provide an incentive to companies to measure and report in a more systematic way on their environmental impact.
Harmonised EU minimum standards for different types of low-carbon indices		
Reduction of search costs driven by higher transparency and comparability of investment products.	Investors and end investors: reduction of search costs (not quantified to prevent double counting with disclosure, which has a more direct effect on search costs).	Due to increased transparency and comparability of the methodologies to develop benchmarks, investors will be more protected from the risk of greenwashing and will not have to invest as much time in analysing which companies/funds are in line with their low carbon preferences. This could also potentially facilitate better access to low carbon investment[9].
Reputational benefits.	Relevant investment entities: potential to gain reputational benefits and attract new customers (quantification varies largely on case-by-case basis due to different size, investment focus and business model; moderate effect expected).	New customers may be attracted as the fund tracking a benchmark which clearly demonstrates a low carbon focus and may be more covered by analysts.
Potentially	Carbon-intensive companies aiming at reducing their	EU minimum standards will recognize the role of

[9] Due to more investment opportunities compliant with the 2°C trajectory.

lower funding costs for projects aiming to reduce carbon footprint.	carbon footprint: not quantified as the benefit varies greatly on case by case basis, but evidence suggests impact of carbon emissions and their disclosure on company value[10], which can likely translate in a change in funding costs.	avoided emissions, carbon-intensive companies aiming at reducing their carbon footprint will be more covered[11] by low carbon funds, which follow relevant benchmarks. Hence, they are likely to enjoy greater access to funding with a reduced funding cost. In turn, this can make carbon reduction projects more economically feasible.
Incentives to invest more in related research.	Wide range of beneficiaries[12] - not quantified due to modelling uncertainty.	As research costs on low carbon strategies drop[13], larger investment in this kind of research can be expected.

Table 2 - Overview of costs

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses[14]		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Harmonised EU framework on ESG factors integration	Direct costs	None	None	Legal & consultancy costs to set up related processes; adapting models and processes (no quantification due to modelling uncertainty)	Relevant investment entities who do not presently integrate sustainability will bear the following compliance costs having been estimated between 0.0001 % and 0.0003 % of AuM maximum per year.	Potential ad-hoc cost of developing guidelines	None/Negligible
	Indirect costs	None	Potential cost pass through to end investors/beneficiaries[15]	Opportunity cost of potential de-prioritization of other consulting projects	Issuers will be incentivized to report relevant data (on a voluntary basis)[16]	None/Negligible	None/Negligible
Mandatory disclosure on ESG	Direct costs	None	None	Compliance costs: up to €40 000 per prospectus[17]; possible consultancy & legal	Research costs (already described above as they are	None/Negligible	Negligible[19]

[10] Matsumura, Prakash, and Vera-Munoz (2011) observe that, on average, for every additional thousand metric tons of carbon emissions, firm value decreases by $212 000 (firms in the sample produced on average 1.07 million metric tons and the model was corrected for self-selection bias), they also found that median value of firms that disclose their carbon emissions is about $2.3 billion higher than that of comparable non-disclosing firms. Guenster et al, (2011) also provide evidence that carbon emissions have a significant and negative impact on company.

[11] As discussed in Annex 9, current prevailing market practice among low carbon funds is to divest from companies with large CO2 footprint or significantly reduce exposure to them. In contrast with this practice, the methodologies provided under the preferred option will help investors to recognize which of the companies in "brown" sectors have projects targeted at reducing their carbon footprint or activities which contribute to lower emission overall.

[12] This includes for instance end investors, public authorities, or general public.

[13] An additional driver of this indirect impact may be a growing demand for low carbon investment products due to label usage and greater comparability.

[14] Unless specified differently, Businesses stand for relevant investment entities in this table.

[15] Limited due to the relatively high degree of competition in the investment sector

[16] The integration of sustainability factors by relevant investment entities may lead to greater demand on disclosure by issuers in order to provide more transparent data. This would induce potential disclosure costs for issuers, which are presently not covered by disclosure requirements on non-financial information.

[17] A transition period will be applied, limiting these costs. Please refer to section 5.5 for more details.

integration both at the level of the entity and of the product				costs to set up ESG disclosure process may arise	needed for integration)[18]		
	Indirect costs	None	Potential, cost pass through to end investors/beneficiaries	None/Negligible	Issuers will be incentivized to report relevant data (already covered above)	None/Negligible	None/Negligible
EU environmental taxonomy with high granularity	Direct costs	None	None	Potential sunk costs for companies which had their own taxonomies[20] Other direct costs depend on final uses of the taxonomy, due to be impact assessed later.	Possible costs when the taxonomy is updated.	IT system adjustment for the use of existing collaborative IT-system (€50 000) for the Platform[21]. Adjustment costs for national labelling schemes that need to incorporate taxonomy	Costs for operating the platform: €3.3 million p.a.[22] Possible costs when the taxonomy is updated for national labelling schemes.
	Indirect costs	None	None/Negligible	Depending on the use of Taxonomy and the technical criteria to be developed (due to be impact assessed later)	Depending on the use of Taxonomy (due to be impact assessed later); issuers will be also indirectly incentivized to report data (on a voluntary basis) as regards the environmentally sustainable activities	None/Negligible	This will depend on the future uses of the taxonomy.
Harmonised EU minimum standards for different types of low-carbon indices	Direct costs	None	None	€50 000-150 000 for benchmark providers who choose to develop new benchmarks[23]; there may also be costs to adjust disclosure processes to comply with new requirements[24]	Compliance costs related to enhanced disclosure[25]	Development of methodology is already covered by recurring costs of the platform of experts on taxonomy	Tracking and enforcing compliance is already covered by recurring costs of the platform of experts on taxonomy
	Indirect costs	None	Potential cost pass-through to end	None/Negligible	'Low carbon' issuers will be	None/Negligible	None/Negligible

[19] While impact monitoring may involve the ESAs, it would be only in the form of adding a question in their existing surveys, whereas none or marginal costs can be expected.

[18] Additional research costs may apply for relevant investment entities who offer funds marketed as "green" due to the requirement to disclose on alignment with the 2 degree climate scenario and carbon impacts. We can at the same time assume that these entities have already a higher expertise available compared to entities which do not offer such investment products.

[20] As argued in section 5.6, these costs are likely to be outweighed by the savings on maintenance of own taxonomy and benefits of EU taxonomy usage.

[21] Please refer to Annex 8 for more information. These costs will be financed through the EU budget.

[22] Please refer to Annex 8 for the breakdown of these costs included. These costs will be financed through the EU budget.

[23] This is an estimated cost for the development of an index by a benchmark provider. As benchmark providers will be able to choose whether to develop a new index under the preferred option, it is safe to assume they will only do so if the expected benefit outweighs this cost; otherwise the cost to them will be 0. By providing a filtering methodology, the preferred option might even reduce this cost of low carbon index development. There may be a cost to a relevant investment entity if it orders a customized benchmark aligned with the methodology, but the same logic applies. Potential switching costs may apply if the underlying benchmark ceases to be suitable according to the methodology.

[24] Please refer to section 5.5 for more information.

[25] Asset managers and institutional investors would bear these costs when they use low carbon benchmarks as a reference point. For details, please refer to section 5.5.

			investors/beneficiaries[26]		incentivized to disclose more information to be included in the indexes (disclosure costs already covered above)		

[26] Costs borne by the industry, such as potential custom benchmark development costs or benchmark switching costs, would likely be passed on to investors, at least in part. However they would also lead to higher transparency and comparability on low carbon product features and alignment with most transparent indices, which may result in an increase in competition. Savings are likely to materialize as well. As listed in the benefits table, we can assume that investment entities will save some money currently dedicated to screening companies (or purchasing external rating). While it is difficult to weigh these impacts against each other, it should be noted that it is more difficult to pass on costs to consumers in a more competitive market.

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EUROPEAN COMMISSION
Regulatory Scrutiny Board

Brussels,
Ares(2018)

Opinion

Title: Impact Assessment / Sustainable Finance Initiative

(version of 26 April 2018)*

Overall 2nd opinion: NEGATIVE

(A) Context

In March 2018, the Commission adopted an EU Action Plan on Financing Sustainable Growth. The Commission has estimated that achieving EU climate and energy sustainability targets by 2030 will require additional annual investments of EUR 180 billion. Much of this would reportedly need to come from the private sector.

This report draws on findings of a High Level Expert Group (HLEG) on sustainable finance. It considers parts of the EU Action Plan to reorient private capital flows towards sustainable investments. In particular, it considers requiring asset managers and others to consider Environmental, Social and Governance (ESG) factors in their decisions. This might improve management of related risks. A new classification system or taxonomy at EU level would lead to a common understanding of what is 'green' or 'sustainable.' Such a taxonomy could also lead to better benchmarks for sustainability.

(B) Main considerations

The Board acknowledges revisions and clarifications to the report. It now explains better a staged development of the project, and how future impact assessments would shed light on elements that will be decided in subsequent legislative acts. It narrows the objectives to focus on clarity and transparency around green finance.

However, the Board maintains its negative opinion, because the revised report still contains the following important shortcomings:

(1) The report is not consistent with regard to making immediate use of the taxonomy. It does not appropriately consider the risks of making the use of the taxonomy mandatory before this has reached sufficient stability and maturity. The report does not examine safeguards against such risks.

* Note that this opinion concerns a draft impact assessment report which may differ from the one adopted.

(2) The report does not explain where and how the six green dimensions of the taxonomy will be made operational.

(3) The report does not sufficiently inform about the costs related to disclosure requirements and fiduciary duties, both for smaller issuers and for financial firms. As a result, it is not clear that the most demanding options for these obligations are proportionate and should be preferred.

The Board considers that the following adjustments are necessary before proceeding further with this initiative.

(C) Further considerations and adjustment requirements

(1) The report should address and consider potential challenges in developing the taxonomy. These might include undesirable diversions of investment activity, unclear ESG compliance requirements, disproportionate costs, a taxonomy developing in sequential stages that delivers flawed or inconsistent incentives and stranded assets, possible encouraged and institutionalised greenwashing, a possible need for third party verification, a litigious environment emerging from a lack of legal clarity and that liquidity in financial markets would suffer from introducing new classes of 'green' securities. This calls for setting appropriate safeguards when legislating use of the taxonomy. The report seems to capture this appropriately for the fiduciary duties and disclosure requirements, but not for the low carbon benchmarks.

(2) The impact assessment sets as its objective for the taxonomy to clarify what sustainable economic activities are. When the report explains what the taxonomy defines and how it is used, it extends beyond this scope to suggest immediate policy uses of the taxonomy as a general principle. This contradicts the provisions on benchmarks and obligations of relevant entities. If the initiative is to require immediate uses, the report should analyse possible options and impacts of those uses.

(3) The report should explain how the taxonomy would deliver a fair assessment of investment characteristics when eligibility criteria differ across sectors and sub-activities. It should clarify how the notions of ‘do no harm’ and ‘contributing substantially to sustainability’ will be made operational across the six green dimensions. The report would need to specify the interaction with EU legislation and objectives. For instance, would an activity ‘do no harm’ if it respects existing legislation or would it need to go beyond minimum legal requirements? The analysis of these issues in the report does not provide sufficient basis for primary legislation that would make the six green dimensions operational. The report should also acknowledge and estimate administrative costs of maintaining such a taxonomy and verifying compliance.

(4) The report should inform about the costs related to disclosure requirements and fiduciary duties. The anecdotal evidence on costs does not suggest that the integration of ESG will be low cost for relevant entities and issuers. It indirectly introduces the need for smaller issuers to disclose material ESG information under the preferred options while they are exempted from Directive 2013/34 on financial statements. Cost considerations may justify re-examining some components of the preferred options, e.g. mandatory disclosure of ESG factors for all financial products and services. This also applies to the low carbon benchmarks, where there is no guarantee that cost considerations will be taken into account in developing the methodology.

(5) The report should better define the content of the ESG factors and inform the reader about the nature of the additional tasks that asset managers will face. The baseline should project the development over time based on current market trends and existing EU policies, including required information that is already being disclosed to the market.

(D) RSB scrutiny process

This opinion is in principle final. The lead DG should seek the appropriate political guidance on whether and under which conditions this initiative may proceed further.

Full title	Sustainable Finance Initiative
Reference number	PLAN/2017/1954
Date of RSB meeting	18/04 2018

EUROPEAN COMMISSION
Regulatory Scrutiny Board

Brussels,
Ares(2018)

Opinion

Title: Impact Assessment / Sustainable Finance Initiative

Overall opinion: NEGATIVE

(Version of 16 March 2018)*

(A) Context

In March 2018, the Commission adopted an EU Action Plan on Financing Sustainable Growth. The Commission has estimated that achieving EU climate and energy sustainability targets by 2030 will require additional annual investments of EUR 180 billion. Much of this would reportedly need to come from the private sector.

This report examines ways to reorient private capital flows towards sustainable investments. It draws on findings of a High Level Expert Group (HLEG) on sustainable finance. The report proposes ways to make sustainable finance more operational. It identifies Environmental, Social and Governance (ESG) factors to consider when making investment decisions. ESG factors would play a role in guiding investment and advice of institutional investors, asset managers and insurers. ESG-related disclosures would increase transparency for end-investors. A classification system (taxonomy) at EU level would facilitate a common understanding of what is 'green' or 'sustainable.' An agreed taxonomy could also promote harmonised methodologies to set benchmarks for sustainability.

(B) Main considerations

The Board notes that the report concerns several mutually supportive initiatives that are at this stage tentative. The Board understands that some elements covered by the report would again be impact-assessed when they are more fully developed. This is reportedly the case for e.g. the taxonomy, the benchmark methodology, the green supporting factor and EU labelling.

However, the Board gives a negative opinion, because the report contains important shortcomings that need to be addressed, particularly with respect to the following key aspects:

* Note that this opinion concerns a draft impact assessment report which may differ from the one adopted.

(1) **The report concerns interrelated measures, for which the scope, sequencing and coherence are unclear. It is also unclear what needs to be decided now.**

(2) **The report leaves open several basic questions with regard to the taxonomy for establishing 'greenness' and how it would be applied.**

(3) **The report does not sufficiently assess potential costs and risks. It does not examine trade-offs between costs and effectiveness. There is a risk that the initiative would not be proportionate.**

(C) Further considerations and adjustment requirements

(1) Issues related to the scope

The context and scope need to take into account existing EU commitments on climate change and the environment. In a number of sectors, EU policies are already defining 'green' performance and promoting private investments e.g. incentivised by emission trading and through climate mitigation projects.

The context should clarify the sequencing of measures envisaged, including for follow-up impact assessments.

The report defines ESG factors loosely, making it unclear where the project's scope starts and where it ends. The focus seems however to lay in environmental and climate change related matters. The dimensions of sustainability, i.e. the social and governance elements, seem to have disappeared in the rest of the initiative, without convincing explanation. This is despite existing national and international initiatives and arrangements which this initiative could build on. It is not clear why the report considers 'governance' separately. However, the term ESG is maintained. The report should better specify the ambition and remit of the initiative.

The report mixes issues on the taxonomy with its use. Options consider legislating requirements to use a taxonomy without providing information about what the taxonomy would look like. It considers moving ahead on fiduciary duties and benchmarks in the absence of the taxonomy. This is arguably premature. The report should disentangle the development of the taxonomy from its use (voluntary versus compulsory).

The report needs to clarify what financial instruments and economic sectors this initiative will apply to, and how.

The initiative considers the development phase of measures but allows for a variety of approaches to making them operational. It is not clear what the final system would look like.

(2) Issues related to the taxonomy

The problem definition and baseline do not take sufficient account of market developments and lessons learned on existing taxonomies. The report should also draw lessons from EU experience to date with labelling for environmental policy.

The taxonomy starts by considering contributions to "green" objectives only, while foreseeing safeguards for social and governance objectives. However, the report should analyse the effects on the taxonomy of the future integration of contributions to social and governance objectives.

The procedure to authoritatively establish what the EU will consider “green” and what is “not green” would involve delegated acts. The impact assessment should map what acts will be required, and estimate how many acts there would be. It should also explain procedures for adjusting the taxonomy in light of future developments, and political oversight of such adjustments. The report does not sufficiently consider issues of how adjustments to the taxonomy would result in compliance costs, enforcement costs and costs to investors. Costs to develop the taxonomy would seem to be higher the more granular the taxonomy is. Risks to asset values due to its dynamic changes could decrease.

The report states that a little more than half of all assets under management in Europe are subject to sustainable investment strategies. This share has increased steadily and given the comprehensive environment and climate change in EU, this is set to increase further. Recently, the retail segment has been growing fast. This contradicts the diagnosis that there is a lack of incentives for investment managers to consider ESG factors. The baseline should take better account of EU's already comprehensive environmental and climate change agenda. The baseline should incorporate the extensive information of the annexes on disclosure obligations and existing methodologies to identify how big the gaps are in the use of ESG criteria.

(3) Specification of options

Given that certain environmental issues are very local (for instance in agricultural and housing sectors), the report should focus on features that are common at the EU level. The relation between the taxonomy and the **green label** is unclear. The text states that EU Eco-label Regulation can be used to create a voluntary EU-wide labelling scheme for financial products. If the relation between the labelling and the taxonomy is unclear, how would increased transparency for end-investors be achieved? If the voluntary green label would co-exist with other sustainability labels at national level, would that not add to confusion? On the **fiduciary duties**, the report needs to be clearer on what is required from asset managers. The report does not identify the concrete additional tasks to be carried out, the information needed and the consequences in terms of costs and burdens. On the **benchmarking**, the report does not specify a method for constructing the benchmark. The report does not sufficiently present the views of, and impacts on, issuers of securities (companies).

(4) Costs and risk assessment

Impacts may cover a substantial part of the financial sector as well as large parts of the private sector. Even if **costs** for specific activities may be limited, as claimed, the sheer scope of it will amount to substantial costs. In places the report judges costs imposed to be limited, though this is contradicted in parts that describe cons of the selected option. The information required for a solid classification will have to come at least partly from issuers, who will face costs to generate this info. These costs have not been estimated seriously. The report ignores impact on smaller issuers (SMEs) who may not have much capacity for generating the required information. The report should clarify impacts on competitiveness of the financial industry and on economic sectors. The report does not make a credible account of the costs potentially involved – for the financial sector as well as for issuers – companies.

The report does not analyse **potential risks**. The risks are different if the taxonomy is voluntary or compulsory. What are risks that operating an ESG taxonomy would result in excessive and disproportionate costs to ensure quality, compliance, updating, consistency with scientific and technical knowledge and to provide legal certainty and prevent greenwashing? What is the risk that 'brown' companies with large projects for reducing carbon footprints will be disfavoured? The intention is that only activities with above average performance relative to the subsector qualify. This would require all activities in the sector to be measured, and the taxonomy to be revised regularly as average performance improves. This has cost implications. Furthermore, this requirement risks discrimination against activities in sectors where the average climate mitigation performance is high. How will fairness and equal treatment for companies be ensured? What is the likelihood that market actors will contest the taxonomy? If the taxonomy is intended to be voluntary, there is a risk that the taxonomy could add to the fragmentation already in financial markets. There is a risk that the sequencing of integration of sustainability factors could have an impact on companies given the existence of trade-offs between for instance environmental and social factors.

(5) Preferred option, monitoring and evaluation

The report should include a full description of the preferred option. The possibility of an empowerment decision for the taxonomy and additional tools through secondary legislation should include all essential requirements. It means that the taxonomy project should be more precise with criteria and safeguards. A pre-condition for delegated acts should be that the taxonomy fully reflects existing standards and legal commitments in the area of climate change and the environment. The Commission should demonstrate the need to go beyond what the legislation says. The monitoring and evaluation framework should also be more targeted. It is not well defined what success of the initiative would look like.

Some more technical comments have been transmitted directly to the author DG.

(D) RSB scrutiny process

The lead DG shall ensure that the report is revised in accordance with the above-mentioned requirements and resubmitted to the Board for its final opinion.

Full title	Sustainable Finance Initiative – fiduciary duty
Reference number	PLAN/2017/1954
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