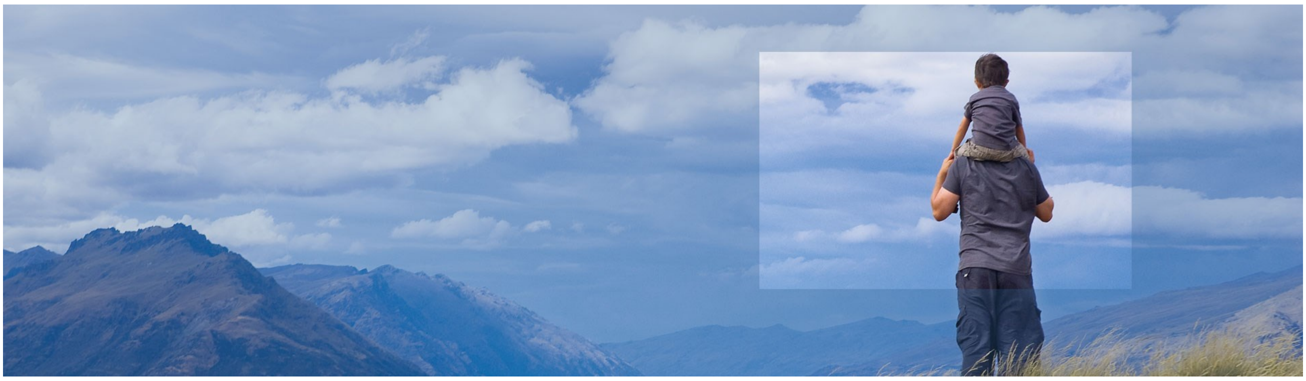
Active is: Being informed of ESG Regulation developments

Sustainable Finance in Europe – Quo Vadis?

by Steffen Hörter | 14/08/2019



Summary

At this stage, the work done by the EU Sustainable Finance Action Plan and Technical Expert Group cannot be ignored anymore. Instead, what investors and the financial community can take action on is to provide constructive feedback on how to execute the regulation most efficiently.

Key takeaways

- Sustainable Finance agenda in the European Union (EU) is being executed rapidly and ambitiously across all asset classes and main financial products. This is no longer a topic of "If"; this is a topic of "How high?".
- ESG Regulation is approaching corporate and investor disclosures, sustainability preferences at investment point-of-sales, sustainability methodologies, investment benchmarking, and green bonds.
- Many actions, such as market testing, have to be taken to adapt to changes, but there are still questions outstanding, e.g. when will fiscal policies like global carbon pricing support sustainable finance?

"How high?" – What is the European ambition on sustainability and what role do investors play?

The EU ambition for sustainable finance is tri-fold. It is to

1 reorient capital flows towards sustainable investment,

2 mainstream sustainability into risk management, and

3 foster transparency and long-termism.

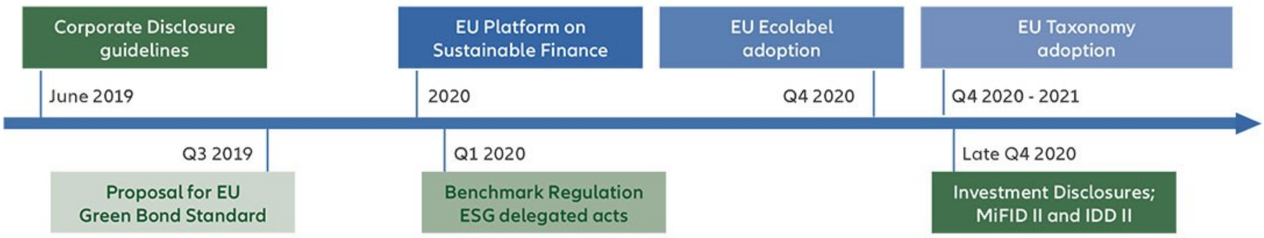
At this stage, the work done by the EU Sustainable Finance Action Plan and Technical Expert Group cannot be ignored anymore. Instead, what investors and the financial community can take action on is to provide constructive feedback on how to execute the regulation most efficiently.

The EU has mobilised many resources in getting the first attempt as right as possible. For example, 160 additional technical sector experts were invited to ensure EU Taxonomy is sufficiently in-depth with the most scientific knowledge available and peer reviews. Noteworthy, **the first movers are not only coming, they are**

already here – EuropeanInvestment Bank's Climate Awareness Bonds areissued in alignment with the EU Taxonomy.

Our expectations from the EU Sustainable Finance regulation proposals
While the EU Action Plan should be viewed as one whole, we aim to dissect the current developments, how each piece of legislation interlinks, and most importantly – What are the investment implications?

Timeline



	Disclosures and Investment Selection	Benchmark Regulation	Green Bond Standards	Taxonomy
What changes?	Funds to disclose on their ESG integration and risk management; MiFID II, IDD, IORP II to include ESG considerations	ESG disclosures for all Benchmarks, and the creation of new Climate Benchmarks	Green bond labelling across the EU	New definition of sustainability established
What implications?	Demand for transparency, scalability, and clear methodology in ESG investments	Transparency for assessment of ESG performance against benchmark allocation	Harmonisation across the EU Green Bond market	Easiest path of lowest resistance to define sustainable investment product
Strictness	Mandatory	Mandatory	Voluntary	Voluntary
Adaptation actions	Develop a robust methodology and process to classify sustainable funds	Ask/provide reporting on ESG and climate for funds and indices	Allocate to compliant green bonds and funds	Company activities to be mapped to Taxonomy

Unresolved questions that still need answers

1 How to scale up the Taxonomy implementation that is addressed by the Technical Expert Group (TEG) workstream? Is the answer mandatory reporting?

"Data Availability is the greatest hurdle for the implementation of Sustainable Finance.
... A detailed user guide is being developed [by TEG], and an internet tool, as well as, usability tests are planned."

TEG panel, Brussels, 2019

2 When will fiscal policies begin supporting the Sustainable Finance developments to level the playing field?

Carbon pricing can serve as a market-based instrument to limit global warming by internalising the costs of and increasing the transparency of the carbon emissions.

Global alignment is necessary to succeed in driving a meaningful change and avoiding regulatory arbitrage.

Fiscal Policies by member states and the EU need to be scaled up to support the sustainability transition.

More sovereign green bond issuances – a green bund or a green gilt?

We expect **a shift in asset allocation and stock selection** towards investment strategies and companies that transparently disclose their ESG profile, risks, and opportunities, with a meticulous methodology. Predominantly, this could be due to rising client demand for ESG through MiFID II, IDD, and regulatory pressure via IORP II.

This is the time for everyone to **pilot test** the Sustainable Finance proposals in the market, for investors to ask and corporates to disclose along NFRD guidelines, to use the regulatory change as a **product innovation opportunity**, and build internal 'star' experts on the many facets of EU Sustainable Finance.

Technical definitions

Taxonomy
Taxonomy refers to the proposal for a regulation on the establishment of a framework to facilitate sustainable investment (2018/0178(COD)). Status as at publishing this paper:

agreement on the position reached in the European Parliament (EP), trilogue ongoing between EP, European Council (the Council), and the European Commission (EC), but developments are likely to be delayed by the current political cycle. The expected adoption of the regulation is to be expected between end-2019 and mid-2022. EU Taxonomy aims to serve as a "dictionary" on the economic activities that are in-line with the six environmental objectives of the EU ; the current TEG work has been published and already covers the first two objectives. The EU Taxonomy can then be used what economic activities of a corporation are sustainable, which potentially can then be aggregated on a portfolio level. The Taxonomy is voluntary to adopt, but it will form the backbone of any future EU ESG Regulation. For example, under the investment disclosures regulation mentioned below, the easiest solution for a fund to explain its selection methodology is to adopt a ready-made Taxonomy.

Investment Disclosures
Investment disclosures refer to the proposal for a regulation on disclosures relating to sustainable investments and sustainability risks (2018/0179(COD)). Status as at publishing this paper: political agreement reached between the co-legislators on the sustainability-related disclosure requirements. This regulation sets out how financial market participants and advisors have to disclose their integration of ESG risks and opportunities in their processes as part of their fiduciary duty. It also sets the broad principles that an investment has to adhere to if claiming to be sustainable. A key piece in this is to disclose the methodologies used to assess, measure and monitor the E&S characteristics or the impact of sustainable investments. Noteworthy, this regulation introduces the notion of adverse impact on ESG matters as an investment consideration, e.g. assets that pollute water.

IDD and MIFID II
ESG in IDD and MIFID II refers to including sustainability considerations in the Insurance Distribution Directive (IDD) and in the Markets in Financial Instruments Directive (MiFID II). On the 04/01/2019, the EC proposed two Delegated Acts to include ESG considerations, which are to be adopted once investment disclosures on ESG will be agreed at the EU level. Status: ESMA has delivered its technical advice to the EC, which is in process of updating the delegated acts. In the meantime, the EC has been very clear in suggesting for investment firms and insurance distributors to already prepare for these delegated acts to come into force. Investment distributors will have to enquire at the point-of-sales, whether their client has ESG preferences, which subsequently shall be reflected in the investment decision.

Benchmark Regulation
AllianzGI is closely involved as a member of the EU TEG on enhancing the ESG disclosures of all benchmarks and the creation of two new investment benchmark categories: a climate-transition benchmark and a Parisaligned benchmark, by amending the Benchmark Regulation (2016/1011). Current status: political agreement reached between the co-legislators with formal rules yet to be approved. The TEG work has been published in its interim version. These developments will require all major benchmark providers to have at least one available benchmark from the newly developed categories. Most importantly, all benchmarks in the EU across different asset classes will have to disclose their ESG characteristics, with significant benchmarks having extra criteria. Currency and interest rate benchmarks are out of scope. The TEG has also developed benchmark decarbonisation requirements coherent with Paris Alignment targets, which can aid in the investment benchmarks to be used for improved transparency, awareness, and comparability.

Green Bond Standard
Green Bond Standard refers to creating an EU-wide label for Green Bond issuances as a result of proposals by the TEG on Sustainable Finance. It builds on the current best market practices, such as transparency and useof- proceeds approach. The standard will be voluntary and applicable to EU or international projects, as well as, applicable to both listed and non-listed bonds. It will comprise of four components: alignment of Green Projects with the EU Taxonomy, a Green Bond Framework, reporting on allocation and impact, and accredited verification, which are further supported by 10 recommendations on how to support and monitor the adoption of the EU GBS. The purpose for this is developing a standard set in legislation, which standardises the Green Bond issuance to improve credibility and transparency. The Green Bond Standard is also very likely to be used as the fixed income verification for the upcoming EU Financial Products Ecolabel.

MiFID II: Markets in Financial Instruments Directive II
IDD: Insurance Distribution Directive
IORP II: Directive on Institutions for Occupational Retirement Provision II
NFRD: Non-Financial Reporting Directive

Sources:
i. Climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy, waste prevention and recycling; pollution prevention and control; protection of healthy ecosystems
ii. European Securities and Markets Authority
iii. Life insurance, Insurance-based investment products (IBIPs), and Undertakings for the Collective Investment in Transferable Securities (UCITS), private and occupational pensions

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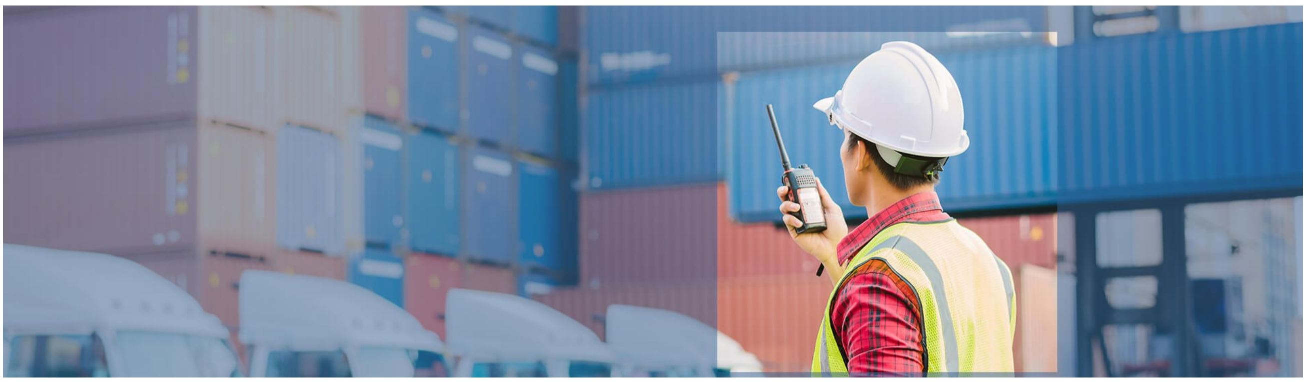

Summary

The day after the Fed announced its new rate cut, an escalation in the trade war sparked market volatility globally. Investors should be cautious while recognising that similar mid-cycle cuts have been positive for risk assets. Consider staying invested with an active and defensive approach.

Key takeaways

- The new round of US tariffs on Chinese goods will likely have an outsize impact on US consumers – an area of relative strength in the US economy
- Barring any unforeseen positive trade news, we expect two more Fed rate cuts this year; these are justified by trade uncertainty alone, in our view
- Similar insurance-rate-cutting cycles have historically resulted in positive returns for risk assets, but trade and tariff woes add risk for the US and global economies
- We continue to advocate for active exposure to risk assets, and our focus remains on defensive and "up-in-quality" assets across markets

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