PRI STATEMENT ON THE EU'S STRATEGY FOR FINANCING THE TRANSITION TO A SUSTAINABLE ECONOMY

7 July 2021

On 6 July, the European Commission published the EU's Strategy for Financing the Transition to a Sustainable Economy. The PRI welcomes this new ambitious strategy, which further strengthens the EU's sustainable finance policy framework and sets a clear policy agenda for 2021-2024.

The renewed strategy comes three years after the EU's Sustainable Finance Action Plan, which laid the foundations for a sustainable financial system in the EU. The EU has followed through on most of the measures announced in its original 2018 action plan, notably a classification system of sustainable activities (EU Taxonomy), a disclosure regime for financial and non-financial companies (SFDR and CSRD) and tools to help investors contribute to the EU's climate goals (EU Climate Benchmark Regulation and EU Green Bond Standard). These are important and ambitious steps, and investors and companies will need time to understand and fully implement the new requirements.

The EU's new strategy aims to build on this foundation by introducing additional measures to align financial flows with the EU's ambitious new sustainability objectives, including a reduction of GHG emissions of 55% by 2030 (compared to 1990 levels).

In this statement, the PRI highlights some of the key measures announced in the strategy and makes some specific recommendations as to how these measures can be successfully implemented.

INVESTING FOR SUSTAINABILITY OUTCOMES

Investor duties to integrate sustainability outcomes

Building a bridge between financial risk and real-world outcomes is the central aim of PRI's 2021-2024 strategy. The PRI therefore welcomes the EU's focus on ensuring a focus on sustainability outcomes are integrated throughout the investment chain. We support the announcement to clarify investors and pension funds' fiduciary duties to take into account sustainability outcomes (or "inside-out" ESG risks of their investments"). Expectations to minimise harms and substantially contribute to environmental and social goals through capital allocation are ever increasing. Clarifying investor duties is therefore an essential step to ensure investors are able to fully integrate sustainability outcomes (both positive and negative) systematically into their investment strategies.

The PRI, together with the UN Environment Programme Finance Initiative and the Generation Foundation, have commissioned legal analysis to determine the extent to which current law enables investors to incorporate sustainability impact in their investment decision-making. This project, **Legal Framework for Impact**, will provide options for policy change to better address sustainability impact as a core part of investment. The project report will be released[1] on 21 July 2021 and followed by a three-year work programme of investor and policymaker outreach.

[1] Global launch webinar: A Legal Framework for Impact Report | Events | PRI (unpri.org)

The PRI encourages the European Commission and the European Supervisory Authorities to draw on the project's analysis when assessing potential obligations to consider sustainability impacts as part of the legal framework for pensions and other institutional investors.

Stewardship rules that better reflect sustainability outcomes

Another crucial aspect of a sustainable financial system is investor stewardship/engagement. In June 2021, the PRI published a position paper setting out five key recommendations to accelerate ambition on stewardship and support the translation of the EU's high-level targets into effective policy reforms, as well as a joint letter calling to include investor engagement as key priority in the renewed EU strategy.

The PRI therefore supports the announced revision of the Shareholder Rights Directive (SRD II) to better reflect impact considerations and global best practices in stewardship guidelines. SRDII recognises that shareholders often exert short-term pressure on investee companies, at the expense of longer-term value creation and ESG issues. The directive seeks to mitigate this by addressing some principal agent problems in the investment chain and provides a minimum baseline for stewardship activities, effective stewardship and long-term investment decision making. However, further obligations need to be recognised and mandated to account for stewardship activities and expectations across all asset classes; and actions investors have taken to implement the stewardship policies and with whom. The revised SRD must also modify the compliance basis from comply or explain to mandatory.

In line with our position paper we also welcome the proposal to provide guidance about collaborative engagement. However, we encourage the Commission to consider the vital role of stewardship even further by:

- Reinforcing the engagement disclosure obligations under the SFDR
- Strengthening the relationship between the Taxonomy, transition-supporting policies and stewardship; and by
- Clarifying that a financial market participant has a duty to consider how it should undertake stewardship activities relating to sustainability risks and impacts to pursue fund objectives and serve clients' "best interests" and may incur reasonable costs in doing so.

FINANCING THE TRANSITION TO NET ZERO

Since its first sustainable finance strategy in 2018, the EU has substantially increased its ambition in addressing the climate crisis – with the European Green Deal setting a coherent framework for achieving the EU's climate and environmental goals.

The EU's new strategy identifies the need for the financial sector to support the real economy's transition to align with these new targets. PRI welcomes the strategy's focus on transition finance and disclosure of forward-looking climate objectives (for both investors and companies). Any future requirements for investors to disclose their forward-looking sustainability targets should take into account existing voluntary efforts – particularly those related to the UN-Convened Net Zero Asset Owner Alliance and the Task Force for Climate Related Financial Disclosures (TCFD). The PRI is particularly supportive of extending companies' strategies to adopt strategic science-based sustainability targets and transition pathways, as these can provide clarity to investors and help them achieve their own net zero targets.

The renewed strategy also proposes new measures under the EU Taxonomy, to support the financing of certain transitional economic activities that could contribute to GHG emissions reductions. While in principle the broadening of the taxonomy is welcome, care is needed as to how this is done. In particular, the Commission's proposed inclusion of natural gas in the Taxonomy is a concern. As the International Energy Agency (IEA) has highlighted, new fossil fuel investment including natural gas, is not compatible with a 1.5c pathway. The European Commission's proposed inclusion of "natural gas and related technologies as transitional activity" in the upcoming climate delegated act therefore risks being at odds with the EU's climate targets. Ensuring that the EU Taxonomy criteria and thresholds are based on the best available scientific advice is vital to maintaining its credibility.

The PRI therefore recommends reverting to the initial recommendations of the EU Technical Expert Group on sustainable finance on the criteria and thresholds for this activity. Any new measure encouraging finance for transitional activities must ensure that it does not lead to the lock-in of carbon intensive activities, as this is not compatible with the EU's climate objectives and latest analysis for what net zero means in the energy sector[2].

With the above in mind, an extension of the EU Taxonomy with clearly defined categories can be helpful to distinguish the different levels of environmental performance. The PRI welcomes these efforts and stresses the importance of the EU Platform for Sustainable Finance's role in defining the technical criteria for these new categories.

A COHERENT FRAMEWORK FOR HUMAN RIGHTS AND SOCIAL ISSUES

The strategy also announces measures to better reflect social issues as part of investor disclosures, under the SFDR. This is welcome, as are efforts by the EU Platform for Sustainable Finance to develop a social taxonomy. Yet more must be done to adequately support workers and communities that will be inevitably affected by the EU's climate transition and ensure that investors and companies are fully taking into account social issues when devising and implementing their decarbonisation plans.

There is also a need for ambitious and mandatory human rights due diligence, as a regulatory baseline for sustainable corporate activity. International guidelines such as the UN Guiding Principles on Business and Human Rights (UNGPs) as well as the OECD Guidelines for Multinational Enterprises (OECD Guidelines) set out companies' responsibility to conduct due diligence to identify, prevent and mitigate, account for and remedy harm in relation to human rights, environmental issues, and anti-corruption. However, research shows that, almost ten years after their formulation, these standards have been only sporadically adopted by companies. This indicates that voluntary measures and disclosure requirements alone have been insufficient to incentivise companies to act responsibly and mitigate negative consequences for people and the environment and associated risks for both companies and investors.

PRI therefore recommends that a legal duty for companies to establish human rights due diligence should be included as part of the broader sustainable corporate governance initiative announced in the new strategy. Together with the CSRD corporate disclosure framework (and ongoing work to develop a social taxonomy), this should create a coherent framework for the systematic consideration of social and human rights outcomes.

FOSTERING INTERNATIONAL CONVERGENCE

Importantly, the strategy recognises that the EU alone cannot solve the sustainability challenges the world is facing. It therefore contains a number of actions that aim to foster international ambition and greater harmonisation on sustainable finance policy. The EU's actions have already had an important impact around the world and will play an important role in setting standards for a global financial framework aligned with sustainability. Europe may benefit from being a first mover, but it must also work with other willing countries, and investors around the world, to ensure progress towards a global framework with sufficient ambition and consistent rules.

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[2] International Energy Agency (2021) – Net Zero by 2050: A Roadmap for the Global Energy Sector. https://www.iea.org/reports/net-zero-by-2050

Many investors operate across jurisdictions, and many EU sustainable finance regulations, such as the EU Taxonomy or the SFRD, require investors to disclose information about the sustainability risks and impacts of their investments irrespective of where the investees are. PRI therefore supports an ambitious and robust global sustainable finance framework that addresses both sustainability risks and opportunities and sustainability outcomes as the basis for harmonisation. The upcoming G20 summit in Rome in October 2021 is a unique and timely opportunity to showcase the EU's leadership role and push for an ambitious global sustainable finance framework.

Taxonomies will play a key role in such a framework and should create a common language between investors, issuers, and policy makers across jurisdictions. Efforts by the International Platform on Sustainable Finance (IPSF) to develop common standards for taxonomies are therefore particularly welcome. The PRI's Policy and Regulation Toolkit sets out key features and design considerations for sustainable taxonomies.

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