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## Sustainable Finance: State-of-play and reflections on the year ahead

2019 is set to be a crucial year in the progression of the European Sustainable Finance Agenda (“Agenda”).<sup>1</sup> It is four years since Sustainable Finance made its first tentative appearance, though a single reference to the need to clarify green bond standards, in the Action Plan on Building a Capital Markets Union.<sup>2</sup> Since then, the scope and ambition of the Agenda have led to unprecedented developments many of which will come to fruition this year.

The work of the High Level Expert Group on Sustainable Finance<sup>3</sup> provided significant thought leadership on how private and public finance can be used as a tool for achieving a stable and resilient financial system while pursuing the goals of the Paris Agreement and Agenda 2030. The subsequent release of the European Commission’s Action Plan on Financing Sustainable Growth,<sup>4</sup> followed by the three legislative proposals in May last year,<sup>5</sup> set a high standard for the role of public policy in steering the crucial reform needed to drive systemic transformations, and set out how the financial sector can truly become a force for driving sustainable positive impacts on the real economy.

The achievements of the past year cannot be understated. The European Commission’s legislative proposal for the mandatory disclosure of sustainability risks by institutional investors (“Disclosure Regulation”)<sup>6</sup> has stimulated a debate on the role of financial materiality in measuring the sustainability of investments, and begun crucial conversations on the role of non-financial impact as a key component when legally defining sustainability risks. The negotiations on the proposed framework to facilitate sustainable investments (“Taxonomy”)<sup>7</sup> have led to a debate on the role of mitigating human rights risks and impacts in the creation of a sustainable financial system, with some stakeholders emphasizing the need for the mitigation of human rights risks in the pursuit of environmentally sustainable activities, while increasingly calling for the creation of a taxonomy that will classify activities leading to favourable social outcomes. Beyond their substantive content, these proposals have brought to light more overarching fault lines for the progression in the Agenda, such as the need to balance a regulatory framework that prevents greenwashing with one that actively seeks to shift capital to facilitate the creation of

a sustainable economy, while moving away from investments that hinder this goal.

In addition to the proposals making their way through the co-legislators, the European Commission called on<sup>8</sup> the European Supervisory Authorities to start laying the groundwork for the integration of sustainability risks into sectoral regulations covering insurance companies, mutual funds, hedge funds, and other financial market players, thus building the stage for a European vision of investors’ duties.

The snapshot above is not exhaustive, but its scope is indicative of the wide range of accomplishments and possibilities for further action in realising the ambitions of the Agenda.

However, challenges remain – not all actions from the Action Plan are completed or in motion. 2019 is not just a crucial year because of the progress achieved under the Sustainable Finance Agenda so far, but also because of the political transitions that ahead. Changes in the Parliament and Commission mandates, accompanied by the political and social uncertainties of the potential departure of the United Kingdom from the European Union, are bound to create additional political uncertainties that can influence the ambition and pursuit of this work.

To respond to these challenges, it is necessary for civil society, trade unions, industry and policymakers to set a roadmap outlining common priorities and ambitions for the year ahead, setting the stage for a subsequent ambitious five-year mandate in the next Commission and Parliament tenures which will see the accomplishment of further ambitious goals within the Agenda. The priorities identified in this statement are intended to provide a snapshot of what some of those ambitions may be.

While not exhaustive, the proposals aim to cover the widest range of financial market players, as well as corporates, and to account for how they are best-placed to contribute to the attainment of the goals of the Sustainable Finance Agenda based on their particular mandates, functions and interactions within and with the investment chain. In addition, the priorities are intended to address sustainability holistically - ranging from climate change to human rights, as well as the need to address financial risk, and to examine the non-financial dimensions of sustainability. The proposals are aimed at policymakers and regulators, focusing on key areas of focus for reform within each proposal.

## Sustainable Finance 2.0

A key priority for the next Commission and Parliament will be to examine an expanding role for the Sustainable Finance Agenda by proposing further policy areas in which the content of the Action Plan can be made relevant.

Notably, such areas could cover fiscal reforms to ensure sustainability-linked externalities are integrated in tax, as well as integrating components of the Sustainable Finance Agenda in the EU's external policies – namely through trade and development.

**Taxation:** Mobilising the capital needed to finance the funding gaps for reaching the Sustainable Finance Agenda's goals is partly contingent on reliable, transparent and fair tax bases. Outlined in the Commission's recently released Reflection Paper, *Towards a Sustainable Europe by 2030*,<sup>9</sup> the role of fiscal reform in achieving these aims should be geared towards measures to combat tax evasion and thus promoting the integrity of the EU's tax base, as well as ensuring that sustainability-related externalities are increasingly appropriately priced and reflected in taxation systems. The success of such fiscal reforms would nonetheless be contingent on ensuring tax burdens are shared proportionately, justly and appropriately by both producers and consumers.

**Trade:** The development of progressive and principles-based trade policy rooted in the promotion of social and environmental sustainability both for the EU and its trading partners is another goal that different components of the Sustainable Finance Agenda could help shape. The central role of responsible business conduct in driving a progressive trade agenda constitutes institutional investors as key stakeholder in influencing and promoting the shaping and implementation Trade and Sustainable Development (TSD) provisions. Tools such as the proposed taxonomy could be useful in delivering and promoting the transparency of the implementation of TSD.

**Development:** The External Investment Plan<sup>10</sup> could serve as another innovative frontier for the application of the Sustainable Finance Agenda. Seeking to attract private investment in order supplement public development assistance for, amongst others, the development of infrastructure projects and the financing of SMEs in developing countries, sustainable finance provisions within the EIP could help guide a clear approach to the mitigation and disclosure of sustainability risks and impacts in channelling these private funds. With mounting evidence pointing to the interconnectedness of economic underdevelopment and societal instability,<sup>11</sup> ensuring private capital flows for the purposes of the EIP are aligned with the objectives of the Sustainable Finance Agenda may not only facilitate the achievement of the Agenda's goals, but more explicitly link the role of financial regulation and responsible investment in preventing global threats that currently seem disconnected from it – such as irregular migration, political fragility and conflict.

## 1. Setting the framework for a sustainable transition

Achieving key reforms through the Sustainable Finance Agenda is contingent on the institutional and governance mechanisms in place to oversee and guide their implementation. In addition, part of creating a framework for reform is contingent on ensuring that key stakeholders, such as supervisors and credit rating agencies, provide the right incentives and guidance in order to facilitate the operational changes within financial institutions and corporates. These two parameters together form the basis for ensuring reforms at a more micro level truly take effect, and set the stage of a financial system geared towards achieving the goals of the Sustainable Finance Agenda.

### Institutional governance

Despite the massive investment gaps in mobilising capital to the sustainable economic, stated to be EUR 180 billion a year,<sup>12</sup> there is very little quantifiable or empirical data available to help in assessing the effect of “greening” the financial sector on the real economy. It is thus

difficult to reliably and accurately assess how the Sustainable Finance Agenda will lead to the reorientation of investment in fixed capital formation. For this reason, it is crucial to ensure the infrastructure is in place to encourage tracking of the EU’s sustainable investment needs. Building on the Commission’s proposal for an EU Sustainable Finance Observatory within the Platform on Sustainable Finance to be established under the auspices to the taxonomy, the co-legislators need to support the development of an institutional mechanism that will track and provide both disaggregated national and aggregated EU-wide data on capital flows and investment needs towards meeting the EU’s sustainability policy goals in order to understand where more attention is needed. From this, it is suggested that the EU Sustainable Finance Observatory should have an advisory role in order make best use of the information collected and leverage changes, through other sustainable finance initiatives, in the real economy.

#### **An institutional framework that promotes the accurate tracking of the impact of the Sustainable Finance Agenda on the real economy must ensure:**

- The creation of an institutional body, namely the EU Sustainable Finance Observatory, has sufficient capacity to oversee the following purposes:
- To advise the EU’s investment and infrastructure initiatives on the areas where more investment is needed, thus leveraging the role of the European Investment Advisory Hub, the Urban Investment Support Hub and the National Promotional Banks to support the upgrade of project development capacity at national and local level. This will lead to an acceleration in the development of high-quality sustainable infrastructure projects and increased match-making of investors;
- To directly support decision-making by both national governments and European institutions in order to encourage evidence-based policy-making on sustainable finance. This includes through supporting Member States in their efforts to develop and employ methods and tools that can track investment needs over time as well as in the development of their low-carbon and sustainable investment strategies (including through National Climate and Energy Plans);
- To oversee the delivery of investments from EU public funds and from the European Investment Bank in line with sustainability objectives, leveraging the use of the taxonomy and sustainability-proofing guidelines, thus aligning public and private investments with harmonised sustainability-related criteria.

## The EU Budget

The EU Budget is an important source of funds for areas from low carbon innovation to clean infrastructure and sustainable regional development. Given the needs for fostering investment in sustainable projects, leveraging private investment alongside public funds is a key part of the Sustainable Finance Agenda. Particularly, for example, in the area of energy efficiency which faces the largest investment gap for decarbonisation and where its potential for delivering wider social benefits largely remains untapped. The EU budget also needs to lead the shift away from fossil fuel investments, the large majority of which goes to gas infrastructure in the EU budget, and significantly reinforce Europe's approach to climate resilience and disaster risk management. Given the EU commitments with the G7 to phase out fossil fuels subsidies by 2025 there is no case for EU budget funding for fossil fuel infrastructure post-2020. The EU post-2020 multi-annual financial framework should be revised to exclude support for unsustainable investments and the EU's public banks should lead the way in a complete shift away from unsustainable investment.

The Action Plan on Financing Sustainable Growth identified the need for the EU Budget to build on the successful roll-out of the European Fund for Strategic Investments (EFSI), providing financial support and related technical assistance to crowd in private investment for sustainable infrastructure. The European Commission has proposed to increase from 20% to 25% of the share of climate-related spending in the next budget, yet it is important that the remaining 75% of the post-2020 MFF is in line with EU's sustainability objectives – this includes within the main sectoral budget proposals involved such as the InvestEU Fund, Connecting Europe Facility, Horizon Europe, European Regional Development Fund and Cohesion Fund. The InvestEU programme will become the EU's main instrument to leverage private investment as the successor of the EFSI. It will have the potential to mobilise public and private investment operations within the EU to address market failures and investment gaps that hamper the achievement of EU goals regarding sustainability, competitiveness and inclusivity.

### **A regulatory framework for the EU budget that fosters investment in sustainable projects while ensuring a complete shift away from unsustainable investment must:**

- Stop funding fossil fuel related infrastructure and target investments in areas of the largest need, utilising the role of the Sustainable Finance Observatory;
- Define clear and consistent sustainability proofing for all the investments within the main sectoral budget proposals, linking closely with the proposal for a EU taxonomy.

## The Revision of the European System of Financial Supervision

As the first legislative initiative in reaction to the Interim Report of the High Level Expert Group on Sustainable Finance, the European Commission presented an omnibus proposal (the “ESAs package”) meant to mandate the integration of sustainability risks in financial supervision. The ambition behind this initiative was widely set by the High Level Expert Group on Sustainable Finance, which took a broad and ambitious view as to how the integration of sustainability risks by financial market participants must be supervised by the three ESAs. In contrast to this ambition, the content of the legislative proposal remained quite general, outlining a broad provision for the supervisors to take account of sustainability risks.<sup>13</sup>

In January 2019, the European Parliament voted on its version of the proposal, reinstating some of the granularity of the HLEG’s original recommendations, and proposing: (1) the assessment of sustainability risks as market developments, including through stress testing and by assessing the influence of these risks on financial stability; (2) the joint assessment by the ESAs and the ESRB of the potential links between systemic risk and sustainability, in particular if it relates to environmental

risks; and (3) the institution of a common monitoring system to assess the material environmental, social and governance-related risks in the development of a common European supervisory culture. Furthermore, the European Insurance and Occupational Pensions Authority announced the consideration of sustainability risks in its 2019 stress test for the occupational pensions sector.<sup>14</sup>

These developments point to the increasing impetus behind clarifying the strong links between the mandates of the ESAs, including the maintenance of financial stability and consumer protection, and the integration of sustainability risks in the conduct of financial institutions. Nonetheless, with the final form of the legislation not yet decided and its implementation expected to be complex, key provisions are still necessary in order to ensure that the mandates of the supervisory authorities are clarified vis-à-vis sustainability. This goal is supported by the Central Banks and Supervisors Network for Greening the Financial System (NGFS),<sup>15</sup> a peer group of Central Banks and Supervisors willing, on a voluntary basis, to exchange experiences, share best practices, contribute to the development of environment and climate risk management in the financial sector, and to mobilize mainstream finance to support the transition toward a sustainable economy.

### **A regulatory and supervisory framework that recognizes the centrality of sustainability for financial stability and consumer protection, embedding it in supervisory mandates, must:**

- Guarantee that a certain percentage of members in the ESAs stakeholder groups have specific sustainability-related expertise;
- Encourage that supervisory functions and monitoring are discharged while adopting an appropriate long-term timeframe in line with both the liabilities of end-investors and the relevance of sustainability risks for the financial institutions at hand, while encouraging the development tools to appropriately gauge those long-term sustainability risks;
- Facilitate the procurement of accurate sustainability-related data by promoting the harmonization of regulatory reporting;
- Encourage the development of qualitative supervisory tools and methodologies for the assessment of sustainability risks enabling financial institutions to increasingly accurately assess the relevance of social and human rights-related risks to their financial resilience, as well as the impact of mitigating human rights risks to financial stability and the prevention of systemic risk;<sup>16</sup>
- Focus on developing quantitative supervisory tools and methodologies for the assessment of sustainability risks, including to enable financial institutions to undertake forward-looking climate scenario analysis<sup>17</sup> as from 2019;
- Encourage dedicated research especially on the topic of the mitigation of sustainability risks and the maintenance of financial stability.



## Credit Rating Agencies

The role of credit rating agencies in establishing and maintaining market norms and influencing investment decision-making to facilitate sustainable investments is a crucial component in achieving impact in the implementation of the Sustainable Finance Agenda. Despite incremental changes in ensuring sustainability risks are properly integrated in the development and provision of credit ratings, key reforms are needed to ensure the consistent assessment and integration of these risks in mainstream ratings. The European Commission and the European Securities and

Markets Authority are both taking an active role in ensuring this agenda come to fruition, by committing to prepare a study on sustainability ratings, and consulting on how sustainability risks can be integrated in ratings,<sup>18</sup> as well as through potentially amending the Credit Rating Agency Regulation. Both institutions must ensure a high level of ambition in further defining the role of Credit Rating Agencies in facilitating the Sustainable Finance Agenda.

### **A regulatory and supervisory framework that ensures credit rating agencies incorporate sustainability risks in mainstream ratings must:**

- Specify sustainability-related disclosure requirements for credit rating agencies, in terms of their ratings and methodologies used in their creation;
- Notably, ensure that credit rating agencies disclose whether the issuer's reporting is aligned with the TCFD Recommendations;
- Mandate the adequate training and competence of all relevant staff employed by credit rating agencies;
- Require the production of "rating outlooks", which include sustainability risks with longer timeframes than credit ratings, applied to all European issuers, showing their exposure to sustainability risks.



## 2. Developing the right tools and incentives

Ensuring the creation of a smart toolbox of practical and effective measures to guide the implementation of the Sustainable Finance Agenda is crucial. Tools such as transparent labels, a robust and holistic taxonomy and a cohesive and coherent framework for corporate reporting and are key instruments in helping to implement the transition to a sustainable financial system and economy.

### Standards and Labels for Green and Sustainable Financial Products

The creation of an EU Green Bond Standard and ecolabel are both crucial in encouraging high standards of transparency and trust in green financial products. This is a key prerequisite for facilitating capital flows, both from retail and institutional investors, to these specific products.

The Commission's Technical Expert Group is currently preparing recommendations for EU Green bond standards for mid-2019; in parallel, developments led by the European Commission's Joint Research Centre are on-going to use the existing EU Ecolabel framework as the basis for an EU ecolabel for financial products.

While these developments are positive, several areas need to be considered carefully to maximize impact. Notably, the absence of clear incentives for issuers to 'go green' due to additional costs for green bond issuers compared to plain vanilla bonds is a source of concern. In addition, more information and better disclosure on the use-of-proceeds in the entire bond markets are also needed so as to level the playing-field for green bonds, which provide additional transparency on a voluntary basis. Moreover, serious concerns remain over the role and responsibility of external reviewers: this requires a credible accreditation scheme for third party verifiers, to protect market integrity, ensure added value and reduce costs.

#### **A technical and regulatory framework that encourages capital flows towards transparent and high-quality green financial products must:**

- Ensure that the EU Green Bond Standard cover and address all critical environmental challenges, ensuring a do-no-harm principle and procedures as suggested in the Parliament's version of the Taxonomy Regulation, to avoid counter-productive negative impacts;
- Promote and mandate more and better disclosure on environmental impacts through the periodic reporting of the impacts of the underlying assets, and ensure the effective use-of-proceeds is aligned with the proposed Taxonomy;
- Mandate external certification by accredited independent verifiers, including instituting a clear withdrawal mechanism of the "EU Green Bond" denomination or label if the results of the verification processes is not in line with the requirements of the certification;
- Facilitate public sector actors to encourage issues to "go green" by setting clear incentives and committing to "lead by example", adopting standardized terms sheets. Sovereign, local or regional governments or public and para-public entities should also lead by example in their strategic issuances and apply standardized terms sheets based on the forthcoming EU Green Bond Standard. Finally, as investors, public entities such as central banks or other public entities should signal a clear preference for green bonds that meet the requirements of the EU Green Bond Standard;
- Mandate the development of an EU Ecolabel for green financial products by focusing on the environmental impacts of investments. Such an eco-labelling scheme should build on (1) voluntary disclosure on the use-of-proceeds under the EU Green Bond Standard and (2) additional disclosures at company-level required under the proposed taxonomy and disclosure regulations (e.g. the share of annual revenues aligned with the EU taxonomy), and be contingent on standardized and more transparent disclosure requirements across the bond and equity investment chains.
- Mandate the development of an EU Ecolabel that will function on a scale instead of be binary, ensure strong thresholds for qualification, and mobilize the new allocation of capital to sustainable investments while being a dependable tool for appropriate re-labelling of old investments. In addition, the Ecolabel should be equally applicable to complex products as it is to shares and savings accounts.

## The Taxonomy

The European Commission's proposal for the classification system to create a common language for sustainable investments has often been called the "trunk" from which the rest of the Sustainable Finance Agenda will grow. The taxonomy will define which economic activities substantially contribute to the achievement of key environmental objectives, underpinned by technical screening criteria to provide granular evidence as to robustness of the framework while ensuring adherence to social safeguards linked to, at the very list, the ILO Core Conventions.

For a robust taxonomy that can truly deliver on its intended purpose to re-orient capital to sustainable investments, it must be aligned to the EU's 2050 ambitions for a climate-neutral economy<sup>19</sup> and have sufficient scope to provide the basis for using such a classification system in a broad set of reforms and by a broad set of actors. The Platform on Sustainable Finance must be sufficiently resourced and transparent to ensure the taxonomy develops in line with these requirements.

### **A regulatory and technical framework for a taxonomy that will truly channel capital towards environmentally sustainable activities must:**

- Consider the wide range of human rights risks resulting from the pursuit of environmentally-friendly activities and provide investors with harmonized processes to comply with concretely-developed minimum social safeguards;
- While also preventing greenwashing, assess the economic activities that substantially harm set environmental objectives and the social safeguards that accompany them, classifying them in the framework of a taxonomy for "unsustainable investments";
- Ensure adequate consideration of economic activities reflecting transitory stages from "unsustainable" to "sustainable" and account for monitoring and guidance in this process, in term of degree of environmental and social performance of activities to facilitate the shift from unsustainable to sustainable activities;
- Assess the role of horizontal governance-related minimum safeguards, which should set clear good governance expectations for companies undertaking the economic activities seeking to be positively classified by the taxonomy;
- Build the blocks for the development of a taxonomy classifying activities contributing to positive social outcomes;
- Be customisable and applicable to different asset classes, covering both equity and fixed income;
- Widen the scope of participants in the Platform on Sustainable Finance, which will oversee the review and development of the taxonomy, by ensuring a balanced representation of civil society, academic, trade union and industry representatives in its membership, including those with specific expertise in human rights.

## Prudential Rules for Banks and Insurance Companies

The release of UNEP FI's Principles of Responsible Banking has brought renewed emphasis to the role of the banking sector in achieving what once originated as a "capital markets-oriented" initiative. While widely absent from the Action Plan on Financing Sustainable Growth, the role of banks in delivering on the goals of the Sustainable Finance Agenda is being increasingly considered by the industry, civil society and policymakers. Concerning prudential requirements, in December 2018, an agreement was reached on the "banking package", mandating the European Banking Authority (EBA) to assess whether the dedicated prudential treatment of assets exposed to

activities associated with environmental and social objectives merit special treatment, and whether the monitoring of ESG risks in national financial regulators is relevant, including through stress-testing and scenario analyses. Finally, banks will be required to disclose their ESG risks starting in three years, first annually, and then bi-annually. Conversely, the upcoming review of Solvency II brings to light the need to assess the prudential treatment of insurance companies from a sustainability perspective, and whether similar consideration ought to be given in the calculation of their own capital requirements through the introduction of green-supporting and brown-penalising factors.

### **A regulatory and supervisory framework that supports the inclusion of sustainability risks in the prudential treatment of banks and insurance companies must:**

- Ensure a science and risk-based approach to the calculation of capital requirements as those are linked to sustainability risks, such as for companies and infrastructure projects predicted to have negative or positive sustainability impacts;
- Ensure that relevant European Supervisory Authorities perform forward-looking climate scenario analysis, as recommended by the TCFD, to assess whether high-carbon activities are riskier than low carbon activities in the short, medium or long term, in the post-Paris Agreement context;
- Ensure a harmonized prudential treatment for banks and insurance companies, appropriately reflecting the provisions of CRD V in the upcoming review of Solvency II.

## Corporate Reporting

The European Commission's Action Plan on Financing Sustainable Growth and the related legislative proposals are a crucial step towards achieving the Paris Agreement and the Sustainable Development Goals by reorienting capital flows to support a sustainable and just economy long-term. This requires enabling private as well as public entities to make sustainable investments to manage risks stemming from environmental, social, and governance (ESG) issues. To achieve this objective, the availability of insightful comparable data is crucial for making well-informed investment decisions, which is why the EU Non-Financial Reporting Directive (NFRD)<sup>20</sup> urgently needs to be reviewed and clarified in order to establish sufficient legal requirements for corporate sustainability reporting.

Besides, this information is also essential for public authorities and civil society to enforce corporate accountability and monitor corporate responsibility. However, at present there is a severe cacophony

in companies' reporting practices, which leads to a lack of concise, consistent, comparable information for investors and other stakeholders.<sup>21</sup>

The review and improvement of the NFRD must lead to the fact that companies need to disclose their risk analysis of how sustainability issues affect the business itself, and at the same time they need to report on their ESG impact in terms of their business model, strategy, products and services. This way, so-called externalities can be factored into financial materiality analyses, which would improve how the financial markets are determined to work in order to spur sustainable finance. A common European standardized sustainability reporting framework is a prerequisite to creating a sustainable, just economy and financial system, and to allowing investors fulfil their existing and upcoming legal obligations to undertake sustainability risk, sustainability impact, and sustainability opportunity assessments when engaging with and investing in companies.

### **A regulatory framework that promotes corporate reporting of sustainability-related information fit for driving sustainable financial markets must:**

- Specify directly in legislation mandatory reporting criteria for most important issues, that are based on international standards and reporting frameworks and which provide the necessary granularity for the production of harmonized information. This concerns in particular transition plans to zero-carbon economy, key performance indicators for environmental impacts, and identification and management of salient human rights issues.
- Expand the application of the non-financial reporting requirements to all large undertakings – regardless of their public/private status, and turnover – as well as to small and medium enterprises which operate in high risk sectors, and require them to publish an annual integrated sustainability report that addresses their full value chain;<sup>22</sup>
- Clarify that directors are responsible for the content of non-financial statements. In addition to mandatory elements specified in the Non-Financial Reporting Directive, the statements should also include a description of a sustainability strategy with accompanying targets adopted by the board of directors as part of their duties;
- Encourage and facilitate alignment between corporate reporting requirements and the provisions of both the Disclosure Regulation and the Taxonomy by ensuring that the production of data is aligned with the technical screening criteria and minimum social safeguards for environmentally-friendly economic activities.

### 3. Empowering key stakeholders to drive reform from below

Top-down regulation can be a key driver of the change in financial sector norms and practices that the Action Plan aims to achieve. Policy makers can also seek to facilitate long-lasting changes through enabling reforms from below, by ensuring that participants in the financial system such as retail investors and employees in the financial sector are able to shape the culture, values and operating principles of financial institutions in ways that promote sustainable finance.

#### Retail Investors

A key force in driving responsible investment, retail investors hold tremendous potential

in shifting capital flows in alignment with the goals of the Sustainable Finance Agenda. Particularly prominent amongst millennials, explicit sustainability preferences are predicted to increase, constituting the offer of sustainable products not just an obligation in response to having to offer appropriate and suitable financial products to clients, but also, a competitive advantage.<sup>23</sup>

Proposed changes to MiFID II and IDD are setting the broad parameters to allow for insurance and reinsurance undertakings and other intermediaries to develop target market assessments with ESG characteristics, and incorporate sustainability preferences in suitability assessments. In addition, the development of an EU Ecolabel is a promising development in ensuring retail funds are transparently marketed.

#### **A regulatory and supervisory framework that empowers retail investors to drive mass capital shifts towards sustainable objectives must:**

- Ensure retail investors can make informed decisions concerning their investments by duly understanding both the investment system as well as the role of sustainability risks and impacts within it, by promoting robust guidance on the development of financial literacy programmes and integrating them in early education;
- Ensure that investor preferences are consulted on and integrated in mainstream financial products, not just those explicitly marketed as sustainable;
- Recognise that retail investors hold both financial and non-financial sustainability-related preferences, and require the consultation of both;
- Encourage the increasing assessment and disclosure of the negative and positive social and environmental impacts of investment to retail investors, allowing them to take a position on “impact risk appetite”, or the impact they are willing to allow their investments to have;
- Ensure that retail investors are transparently advised on how the whole range of products within a given portfolio are aligned with their expressed preferences, not just specific products meant to be tailored to those preferences. While aligning the entire range of products within a portfolio with those preferences may not be a necessity if the client so decides, assessment of this alignment and disclosure to retail investors should, at the very least, form part of the suitability assessment process;
- Ensure that the relevant European Supervisory Authorities provide detailed guidance on how to integrate sustainability-related preferences in the suitability assessment process, including a potential standard questionnaire to help clarify sustainability-related preferences of retail investors.

## Financial Sector Employees

The needs and perspectives of employees should play an important role in the process of creating and implementing financial legislation, including on sustainable finance. While financial sector employees are the ‘face’ of the financial market to customers, they also have the capacity, together with trade unions, to act as catalysts in their work environments and carry the vision of sustainability.

In the wake of the financial crisis, the EU rolled out a record number of new financial legislation. While, understandably, actions were needed to stabilize the financial market, ensure consumer protection and (re)build trust, the effects of the new requirements on employees remained largely unconsidered;<sup>24</sup>

In addition to the pressure of compliance and new regulatory requirements, conflict of interest between good customer service and following rules and regulations was one of the main areas of concern for employees;

If the new requirements within the sustainable finance agenda are to be successfully implemented, the employee perspective and impact, as well

as possible spill-over effects to the quality of customer service, need to be among ‘top of mind’ considerations;

For financial sector employees to play an active and positive role in the transition to sustainable finance, and to successfully work with compliance and implementation, they need to receive appropriate education and training;

Lack of transparency and long-termism still remain as some of the biggest challenges in the financial sector’s transition to sustainable finance. Both financial sector employees and trade unions can be important stakeholders in the process of mindset shift;

Digitalization and short-termism in the financial sector are also affecting access to finance. Digital exclusion leaves a big part of the European population behind, impeding their possibility to receive financial advice, seize possibilities to grow, and potentially contribute to the wider cause of sustainability. At the same time, this creates a burden on financial sector employees, as they face limitations in providing the advice that they would like to give.

### **A regulatory framework that empowers financial sector employees and trade unions to act as key catalysts in the creation of a sustainable finance system must:**

- Include employee-focused impact assessments for all financial regulation, which can qualitatively assess the effects of proposed financial regulation on those involved in ensuring its implementation;
- Ensure employees have the right to provide advice reflecting the sustainability-related preferences of their clients, instead of advice leading to the selling of products linked to maximised profits;
- Ensure that all financial sector employees working in advisory functions have received adequate training on sustainability, including specialised dilemma training;
- Protect the right of customers to receive sound, personal financial advice, including as it relates to sustainability;
- Protect the rights of employees to “blow the whistle” on violations and discrepancies regarding the sustainability-related suitability of financial products;
- Ensure the representation of trade unions in the Permanent Platform overseeing the review and development of the proposed Taxonomy.

## 4. Developing processes and guidance to shape key investment duties

The topic of investment duties has received fair attention in the Sustainable Finance Agenda, starting with the Interim Report of the High Level Expert Group on Sustainable Finance. With the Commission and European Supervisory Authorities now working to better define how duties should be better defined across sectoral regulations, it is crucial to develop an overarching vision for what these clarifications are meant to achieve. The end-goal of how these duties should be developed must include a prominent role for the role of responsible stewardship in linking the financial system with tangible changes in the real economy.

### Investors' Duties

The work of the High Level Expert Group on Sustainable Finance outlined the necessity of achieving a harmonized view of what it means for investors to act in the best interests of their clients and beneficiaries, known in common-law traditions as fiduciary duty.<sup>25</sup> While commonly reflected in EU sectoral regulation by widely accepted behavioural precepts, such as the prudent person rule, practical implementation has tended to equate “acting in the best interest” with the maximisation of short-term profit while widely bypassing the validity of so-called “non-financial” factors, such as sustainability risks, in investment decision-making.

Research has since clarified that the proper discharging of investors' duties towards end-investors mandates the integration of financial sustainability risks in investment decision-making, a conclusion also echoed in the Final Report of the HLEG, as well as in the Commission's Action Plan on Financing Sustainable Growth.<sup>26</sup> Nonetheless, much more remains to be clarified, as an overarching, modern vision for what the nascent European vision of investors' duties should include is widely absent from this process. Such a vision needs to set a progressive standard for how investors must consult on, assess, and interpret the best interests of their clients and beneficiaries, while also increasingly linking the protection of these interests to the assessment and measurement of the impact of mainstream investments on communities and the environment.

(1) Asset owners should be actively consulting with retail clients, policyholders and beneficiaries in ascertaining sustainability preferences, while implementing institutional arrangements to ensure these end-investors are able to influence investment decision-making, such as through board representation on pension funds;

(2) Sustainability preferences should not be limited to those that are financially material, but include non-financial considerations, such as those related to quality-of-life or ethical concerns. The circumstances under which the latter category can or should be incorporated in mainstream investment decision-making, beyond designated “impact” or “ethical” products and services, must be better defined;

(3) The integration of both risks and preferences should be aligned with the time horizon reflecting the liabilities of the end-investor, requiring renewed emphasis on issues of intergenerational equity when referring to classes of current and future beneficiaries are pooled together;

(4) Asset owners must extend mandates to managers and any other intermediary reflecting both the substantive content and the time horizon of their clients' preferences;

(5) Asset managers must exercise their shareholder rights and wider company engagement efforts in alignment with the preferences of their clients' end-investors, including through duly considering conflicts of interest as those relate to sustainability in the exercise of these functions;

(6) In order to account for the non-financial sustainability preferences of their clients, as well as to respond to the systemic,<sup>27</sup> non-linear nature of some sustainability risks, investors should assess the impact of their investments on communities and the environment, independently of whether those are reflected in the value of their portfolios within conventional timeframes. While the financial relevance of sustainability risks has garnered significant empirical evidence, some of these risks may continue to be externalities, extremities or overly complex<sup>28</sup> for current accounting and reporting frameworks, mandating an increasing emphasis on accurate impact measurement of investment activity on communities and the environment. This information can thus help promote a more approximate understanding of externalities, as well as risks that may not be conventionally considered.



**A regulatory and supervisory framework for a European vision of investors' duties should:**

- Mandate that end-investors, including occupational pension beneficiaries, policyholders and retail investors, are consulted about their sustainability-related preferences;
- Clarify the conditions under which the non-financial sustainability preferences of end-investors can be taken into account in mainstream investment decision-making;
- Promote the alignment of investment time-horizons with the liabilities of end-investors and ensure an appropriate consideration of sustainability risks within that timeframe, particularly as those relate to future pension beneficiaries and insurance policyholders with long-term liabilities;
- Ensure the transmission of the financial and non-financial interests of end-investors throughout the investment chain by guiding the extension of mandates reflecting those interests from asset owners to asset managers, as well as other intermediaries;
- Encourage the development of tools and methodologies to assess the impact of investments on communities and the environment, independently of whether these impacts are reflected in the value of a portfolio.

## Stewardship

Asset managers are key catalysts in driving the savings of billions of savers through capital markets. The volume of these savings is tremendous: as of 2017, 71% of assets under management in the EU are linked to institutional investors whose clients and beneficiaries often have long-term liabilities, such as pension funds and insurance companies.<sup>29</sup> By channelling these savings towards corporates, asset managers serve a key link between the financial system and the real economy. The role of stewardship in ensuring the transition to a sustainable economy, such as through the exercise of shareholder rights to promote sound corporate governance systems that are conducive to long-term and sustainable business activity, as well as through ensuring robust and sustainability-proof company engagement strategies, is crucial. Nonetheless, in the context of the Sustainable Finance Agenda, the role of stewardship in driving sustainability to the centre of financial markets has received comparatively less attention than the use of more potentially binary tools in directing capital flows– such as the proposed taxonomy.

Ensuring a regulatory ecosystem that promotes long-term stewardship and responsible engagement between institutional investors and their investee companies is contingent on assessing the interaction of different components of the Sustainable Finance Agenda, such as disclosure, the integration of sustainability risks in investment strategies, and even effective consultations with end-investors on behalf of asset owners, who must then ensure that those preferences be reflected in the stewardship expectations set out in their mandates to asset managers. On their end, asset managers need to ensure transparent and accurate information-sharing with their underlying clients on how their stewardship activities align with the mandates extended to them, as well as, amongst others, how they expect and manage conflicts of interest in contracting proxy services to advise and guide the exercise of shareholder rights.

### **A regulatory framework that promotes stewardship as a key driver for sustainability must:**

- Provide guidance for managers on how to assess the effectiveness of their engagement efforts, while outlining clear roadmaps for escalation tactics, as well as the circumstances under which divestment is in line with the managers' duties towards their clients;
- Mandate the disclosure of sustainability-related shareholder voting and instructions extended to proxy advisors worldwide. Disclosure must include contentious votes, such as votes where more than 10% were cast against company management's recommendation, and abstentions, including the rationale behind them;<sup>30</sup>
- Mandate the disclosure of wider company engagement efforts, including the number, topic, and context in which the engagements take place, and a list of or extensive examples of companies engaged with – as well as the impact and results of these engagements;
- While maintaining flexibility, better clarify expectations concerning an effective operationalisation of the comply-or-explain governance principle across European stewardship codes, to ensure it is used to adequately provide meaningful explanations when sustainability-related engagement strategies are not complied with, thus truly being used as a tool to promote accountability and behavioural change;
- Assess the fitness of the Shareholder Rights Directive under the Sustainable Finance Agenda, and further legally mandate the mandatory development of sustainability-related engagement strategies for both passive and active managers, while providing stronger guidance on the aforementioned topics to guide the transposition of the Directive.

## 5. Ensuring accountability for the integration of sustainability risks and factors

Achieving substantive reforms in the Sustainable Finance Agenda would be incomplete if it just centred around setting expectations and providing the right tools. While this constitutes a crucial component of reaching scale, ensuring a framework to promote accountability both in the investment sector, as well as corporates, should form part of the regulatory framework needed to ensure a lasting transition to a sustainable and just financial system, while providing a predictable level playing-field for industry actors.

### Mandatory Due Diligence Requirements for Investors

The Action Plan on Financing Sustainable Growth has called for the mainstreaming of sustainability issues in investors' risk management. The subsequent legislative proposal for a Regulation on Disclosures Relating to Sustainable Investments and Sustainability Risks (DSR Regulation) introduces disclosure obligations on how investors integrate ESG factors in their risk processes. This legislation is currently in the final stages of negotiations and potential agreement.

However, disclosure alone will not lead to the necessary reform of the financial sector the EU needs in order to respond to modern social and environmental sustainability challenges. Therefore, we support the regulatory introduction of a robust investor due diligence through better regulation of financial systems.

Due diligence has long been used by companies and their lawyers to describe a range of investigative processes carried out to identify risks to a company before entering into a business transaction. Therefore, in relation to human rights and ESG risks, the term "due diligence" describes an ongoing risk management process in order to identify, prevent, mitigate and account for how a company addresses its adverse human rights impacts. The focus is on risk to people, not the business or investors, while recognizing that where risks to people and planet are greatest, there is significant overlap with risk to the business.

Due diligence as outlined by the UNGPs has been integrated as a key feature of OECD Guidelines on Multinational Enterprises (OECD Guidelines), and a growing number of countries, business associations, companies and NGOs have incorporated this framework into legislation, policy commitments and advocacy efforts. Specifically for investors, we recommend the sector specific process of due diligence as outlined in the OECD Guidance – Responsible Business Conduct for Institutional Investors – Key Considerations for due diligence under the OECD Guidelines for Multinational Investors (2017).<sup>31</sup>

This framework, agreed upon by the OECD, institutional investors, governments and civil society organisations (CSOs) is the key international standard outlining how investors must manage their impacts on people, communities and the environment and should be used as a clear reference for the development for mandatory due diligence requirements in the context of the Disclosure Regulation. Due diligence is a key component of properly mitigating sustainability risks.

#### **A regulatory framework that encompasses mandatory due diligence for investors must:**

- Specify the need for investor due diligence as a prerequisite to appropriate disclosure, including in the context of the Disclosure Regulation;
- Provide investors with clear guidance on what the due diligence process entails, in line with the OECD guidance, and provide them with the tools to discharge their obligations to implement it as part of their identification, prevention and mitigation of the sustainability risks and impacts in their investment decision-making.

## Clarifying Directors' Duties

The Sustainable Finance Agenda, in particular through Action 10, has given sound consideration to the role of corporate governance in facilitating corporate accountability and by achieving it contributing to the creation of a sustainable financial system. The Action Plan proposes to consider requirements on corporate boards to create and disclose sustainability strategies covering the entire supply chain, as well as a legal clarification of the duties of company directors to act in the company's long-term interest.

A corporate governance framework characterised by these two developments would improve directors' accountability for conducting environmental and social due diligence. Using the UN Guiding Principles on Business and Human

Rights as the authoritative standard, it could pave the way for an overarching corporate duty to identify, prevent, mitigate and remedy the environmental and human rights impacts linked to business activities that could be enforced by affected people, as is currently established by the French Duty of Vigilance Law. Furthermore, introducing environmental and human rights due diligence requirements in directors' duties would contribute to the transition from shareholder primacy norms that dominate corporate governance to a model that respects rights and interests of stakeholders, while strengthening financial market participants' means to positively influence corporate boards in this regard.

### **A regulatory framework that promotes sound corporate governance must:**

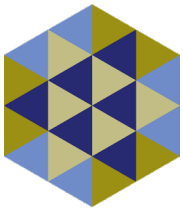
- Clarify that company directors' duties are subject of the company's own, rather than exclusively shareholders' interests;
- Clarify that in the execution of directors' overarching duty to act in the best interests of the company over time, directors should exercise a duty of care towards the interests of the wider stakeholders influenced by corporate activities;
- Require company directors to identify and mitigate all of the social and environmental factors that materially influence the long-term prosperity of their companies as a whole, and the attainment of its specific social objectives;
- Institute clear requirements for the boards to develop a sustainability strategy that respects planetary boundaries and human rights and implementation of environmental and human rights due diligence, aligned with the UN Guiding Principles on Business and Human Rights;
- Explicitly address the issue of corporate liability for environmental and human rights impacts and enhance access to judicial remedy for affected people.

## Notes

1. The term is used to denote the work of the High Level Expert Group on Sustainable Finance, the Action Plan on Financing Sustainable Growth, and subsequent legislative and non-legislative initiatives.
2. European Commission (2015). *Action Plan on Building a Capital Markets Union*. COM (2015) 468 final.
3. The High Level Expert Group on Sustainable Finance brought together 20 experts from civil society, financial services and academia to advise the European Commission on how to integrate sustainability considerations in EU financial services regulation.
4. European Commission (2018). *Action Plan on Financing Sustainable Growth*. COM (2018) 97 final.
5. The three legislative proposals included the Proposal for a regulation on the establishment of a framework to facilitate sustainable investment (COM (2018) 353), Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 and the Proposal for a regulation amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks (COM (2018) 355).
6. COM(2018) 354.
7. COM(2018) 353.
8. European Commission (2018). *Formal request to EIOPA and ESMA for technical advices on potential amendments to, or introduction of, delegated acts under Directive 2009/65/EC, Directive 2009/138/EC, Directive 2011/61/EU, Directive 2014/65/EU and Directive 2016/97/EU with regard to the integration of sustainability risks and sustainability factors*.
9. European Commission (2019), *Reflection Paper: Towards a Sustainable Europe by 2030*.
10. [https://ec.europa.eu/commission/eu-external-investment-plan\\_en](https://ec.europa.eu/commission/eu-external-investment-plan_en)
11. See Brunnschweiler, Christa and Päivi Lujala (2017). Economic Backwardness and Social Tension. *Scandinavian Journal of Economics*.
12. This figure is however out of date based on the fact it uses a 2016 reference scenario and only a 30% energy efficiency target to 2030, whereas the agreed target is 32.5%.
13. A new paragraph is added to the Regulation for each ESA (under Article 8 - Tasks and powers of the Authority): "When carrying out its tasks in accordance with this Regulation, the authority shall take account of technological innovation, innovative and sustainable business models, and the integration of environmental, social and governance related factors".
14. IPE (2018). *EIOPA confirms ESG risk assessment in 2019 pension fund stress tests*.
15. Banque de France (2018). *First meeting of the Central Banks and Supervisors Network for Greening the Financial System (NGFS)*.
16. See, for example Dowell-Jones, Mary & Kinley, David, "Minding the Gap: Global Finance and Human Rights." *Ethics & International Affairs*, Vol. 25, No. 2, pp. 183-210, 2011; *Sydney Law School Research Paper* No. 11/37.
17. Precedents by NCAs are an opportunity to mainstream best practice at EU level, develop skills and capacity, and exchange initial findings in an anonymised way. It should clarify how financial supervisors can use forward-looking climate scenario analysis, built on standardised climate scenarios (notably a well below 2°C scenario), to check portfolio alignment with the Paris Agreement and the climate-related value at risk from financial institutions. This will ensure consistency with the TCFD recommendations. Importantly, such climate scenario analysis (long term-oriented research) is not similar to stress tests (short term shock testing) and thus does not have heavy implications (e.g. on capital requirements), so could proceed relatively quickly.
18. European Securities and Markets Authority (2018). *Consultation Paper, Guidelines on Disclosure Requirements Applicable to Credit Ratings*.
19. European Commission (2018). *A Clean Planet For All: A European strategic long-term vision for a prosperous, modern, competitive and climate neutral economy*.
20. European Commission (2017). *Guidelines on non-financial reporting (methodology for reporting non-financial information)* C/2017/4234. Examples to refer to: GRI, CDP, TCFD, IIRC, OECD Guidelines for Multinational Enterprises, ILO and ISO Standards, UDHR, etc.
21. The results of the Alliance for Corporate Transparency Project research in 2018 show that the ESG information disclosed by European companies is not clear enough in terms of concrete issues, target and risks. For example, of the 105 companies analyses, 90% of companies report on climate change, but merely 47% specify clearly what precisely their policy has been designed to achieve and how. Similarly, over 90% of companies express in their reports a commitment to respect human rights but only 36% describe their human rights due diligence system.

22. Some member states already dropped the employee threshold number from 500 to 250 employees (TEG report 2019) therefore aligning the threshold with the definition of a large undertaking in the Accounting Directive, i.e. 250 employees.
23. For example, see Abou-Jaoudé, N. (2018) "Millennials and women key drivers of socially responsible investment." *European CEO*; and Chatzky, J. (2018) "How millennials are changing the way we invest." *NBC News*.
24. According to Nordic Financial Unions (2018), *Coping with Compliance*, approximately 80% of the respondents experience that the amount of requirements on documentation, information to consumers and KYC have increased, while describing a work environment filled with stress and pressure.
25. As outlined in the 3rd Priority of the HLEG's Interim Report.
26. See, for example ShareAction (2011), *Protecting our Best Interests*; UNPRI (2015) *Fiduciary Duty in the 21st Century*; European Commission (2014) *Resource Efficiency and the Fiduciary Duties of Investors*.
27. For example, see ESRB (2016), *Too late, too sudden: Transition to a low-carbon economy and systemic risk*.
28. Cort, Todd (2015). "Black Swans and Sustainability." *Environmental Leader*.
29. EFAMA (2018). *Asset Management in Europe*, 10th Edition, Facts and Figures.
30. ShareAction (2017). *Lifting the Lid: Responsible. Investment Performance of European Asset Managers*.
30. OECD (2017). *Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises*.

## Contributors



# E3G

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[E3G](#) is an independent climate change think tank operating to accelerate the global transition to sustainable development.



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[The European Coalition for Corporate Justice \(ECCJ\)](#) advocates for European laws that guarantee corporate accountability and transparency, and ensure justice for victims of corporate malpractice. With 18 member groups representing over 200 organisations from 15 countries, ECCJ is the only European coalition bringing together campaigns and national platforms of NGOs, trade unions, consumer organisations and academics in order to promote corporate accountability. We are guided by a vision of a sustainable world in which corporations' drive for profit is balanced with the interests of society at large, and where businesses respect human, social and environmental rights.



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## Contributors



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Many of the world's worst environmental and human rights abuses are driven by the exploitation of natural resources and corruption in the global political and economic system. [Global Witness](#) is campaigning to end this. We carry out hard-hitting investigations, expose these abuses, and campaign for change. We are independent, not-for-profit, and work with partners around the world in our fight for justice.

Our 25 years of experience of linking the exploitation of natural resources and international trade systems means that we have developed effective and successful methods, based on robust data and evidence, for achieving essential and systemic global change. We focus on addressing the root causes of why natural resource exploitation fuels some of the most widespread and brutal human rights abuses, corruption and environmental degradation.



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[NFU - Nordic Financial Unions](#) builds cooperation among Nordic financial trade unions and promotes their interests in Europe. Through a high level of competence and dialogue, NFU contributes to shaping a sustainable financial sector, fundamental for job creation. Currently, NFU represents seven trade unions in the bank, finance and insurance sectors in all the Nordic countries.

## **ShareAction»**

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[ShareAction](#)'s vision is a world where ordinary savers and institutional investors work together to ensure our communities and environment are safe and sustainable for all. Our mission is to unleash the positive potential of the mainstream investment system.

## Contributors



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The organisation [SustainableEnergy](#) has been developing sustainable development solutions since 1975. Independent from commercial and political interests we develop and promote solutions that see carbon reduction and social justice as intertwined, e.g. in our work with the community power model that drove development of the wind industry in the 1990's.



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[UNI Europa Finance](#) is the European-level trade union body for the finance sector. It represents 100 unions with 1.5 million workers in the banking and insurance industries. UNI Europa Finance is part of UNI Global Union and recognised by the European Union as a social partner.



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[The WWF European Policy Office's \(EPO\)](#) mission is to stop the degradation of the planet's natural environment and to build a future in which humans live in harmony with nature. The WWF EPO advocates on the EU level for a more sustainable future for people and planet.

