European strategy for Impact Financing – a brief overview

Impact Financing

Impact financing is the growing market phenomenon whereby investment and lending decisions are being driven partly (or even primarily) by considerations of the sustainability of the target enterprise and the impact that the investment is likely to have on given Environmental Social and Governance priorities and/or on the attainment of one or more of the UN Sustainable Development Goals. There are a lot of overlapping ideas and terminology but two central, mutually reinforcing, ideas emerge - that of reduced risk and a better world. Sustainability and in particular environmental concerns are increasingly relevant to the structuring drafting and regulation of finance transaction.

The EU Action Plan

"Sustainability is the theme of our time – and the financial system has a key role to play in delivering that set of ambitions" remains a key statement of the Final Report 2018 by the EU High-Level Expert Group on Sustainable Finance *("**HLEG**")*.

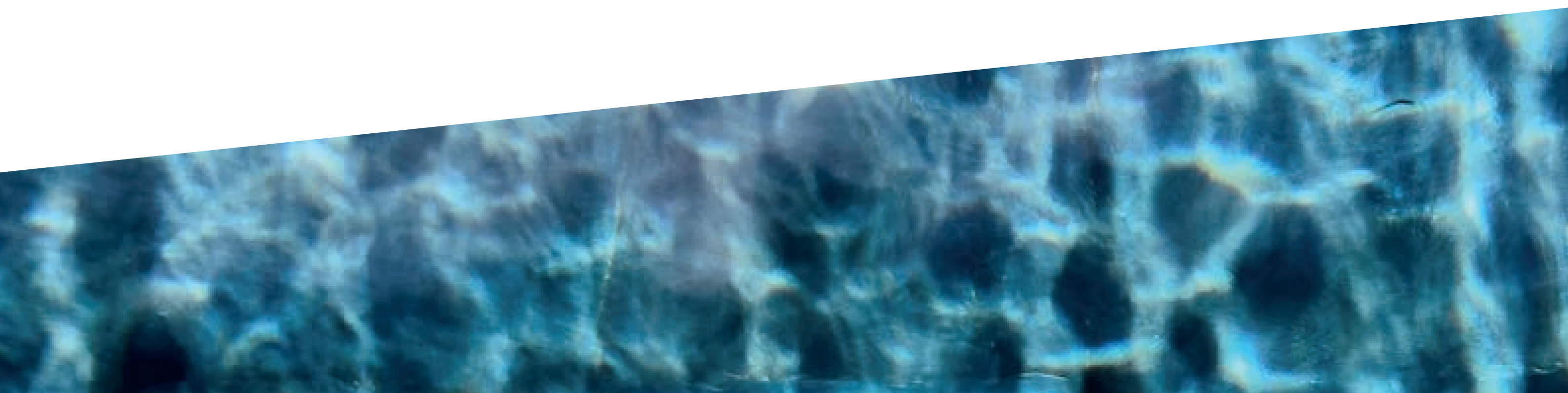
It has become increasingly evident that if key climate and sustainable development goals and policies (such as the United Nations Framework Convention on Climate Change, the Sustainable Development Goals and the Paris Agreement (to name a few)) are to be implemented and achieved this is not a task for the public sector alone. The EU has played a leading role in the development of these policies and goals, reflecting them in EU policies, identifying the challenges which remain and outlining the solutions required. The EU has identified that the private financial sector has a vital role to play not only in mobilising capital to deal with the identified significant shortfall of available capital but also in financing long term sustainable growth and contributing towards a low-carbon, climate resilient and circular economy.

In March 2018, the EU Commission, building on the HLEG's recommendations, published an action plan "Financing Sustainable Growth" which set out the EU's strategy for impact financing, its plan to align financial and global climate goals as required under the Paris Agreement and how it intends to contribute to achieving the UN 2030 Agenda for Sustainable Development (the "**EU Action Plan**").

The EU Action Plan has three main objectives aimed at reorienting capital flows towards sustainable investments to achieve sustainable inclusive growth, mainstreaming sustainability risk management and fostering transparency and long-termism in financial and economic activity.

In order to achieve these goals, the EU Action Plan sets out the following ten steps:

1. Establishing an EU classification system for sustainable activities (taxonomy)
2. Creating standards and labels for green financial products
3. Fostering investment in sustainable projects
4. Incorporating sustainability when providing financial advice
5. Developing sustainability benchmarks
6. Improving integration of sustainability factors in ratings and market research



7. Clarifying institutional investors' and asset managers' duties
8. Incorporating sustainability in prudential requirements
9. Strengthening sustainability disclosure and accounting rule-making
10. Fostering sustainable corporate governance culture and attenuating short-termism in capital markets

Implementation of the EU Action Plan

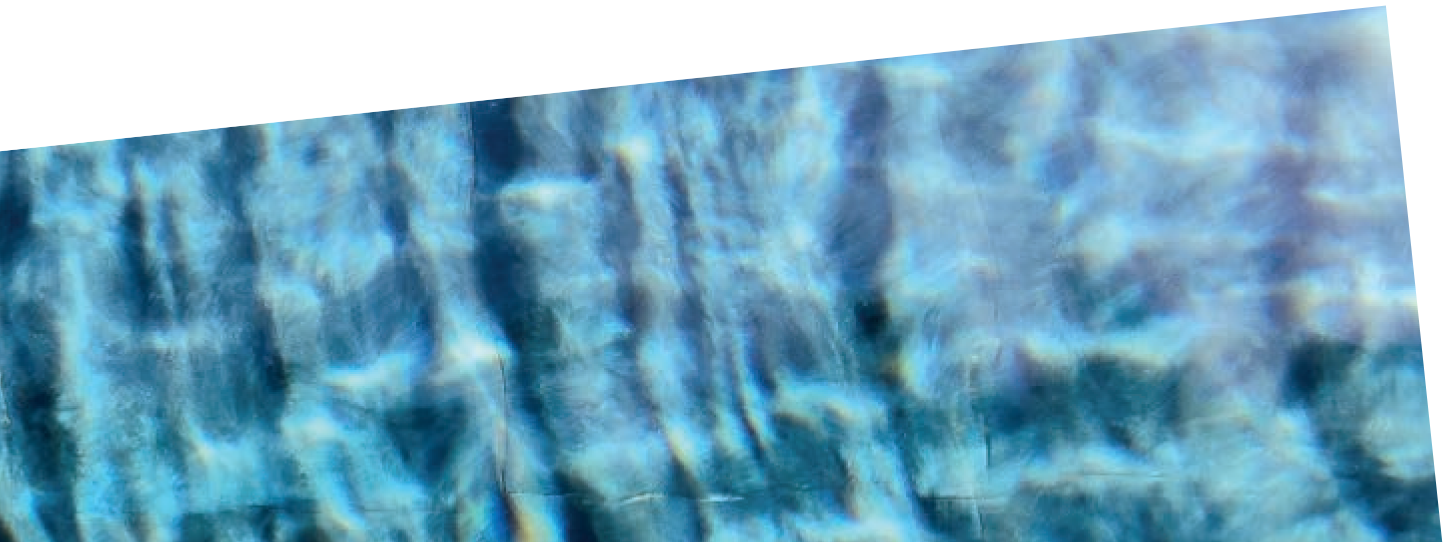
In May 2018, the European Commission implemented several key actions from the EU Action Plan including three proposals for regulations aimed at establishing a unified EU classification system of sustainable economic activities (taxonomy), improving disclosure requirements on how institutional investors integrate ESG factors into their risk processes and creating a new category of benchmarks which will help investors compare the carbon footprint of their investments. The timeframe for the implementation is extremely ambitious – the relevant delegated acts shall enter into force between 2021 and 2022.

The EU Action Plan also recognised the need for non-legislative as well as legislative actions (including possible amendments to IORP II, PEPP, Solvency II, MiFID II, UCITS, AIFMD, Shareholder Rights Directive, Non-Financial Reporting Directive, EuVECA and ELTIF). These are aimed at clarifying how finance parties (including asset managers, insurance companies, and investment or insurance advisors) should integrate sustainability risks and factors within their organisations and also consider risk assessment and management processes.

In June 2019, the European Commission published 3 new TEG reports (relating to taxonomy, EU Green Bond Standard and benchmarks and methodology) and published new guidelines on corporate climate-related information reporting providing companies with practical recommendations on how to report the impact their activities have on the climate and also the impact of climate change on their business. This guidance applies to approximately 6,000 EU-listed companies, banks and insurance companies required to disclose non-financial information under the Non-Financial Reporting Directive. The intention is that the corporate disclosure updates the non-binding guidelines relating to the Non-Financial Reporting Directive and The Green Bond Standard recommendations will form the basis of a future voluntary EU Green Bond Standard.

The EU has also sought opinions and advice from other international organisations in order to address action 10 (i.e. financing sustainable growth that aims at fostering sustainable corporate governance and attenuating short-termism in capital markets) including an opinion from EIOPA on sustainability within Solvency II and from ESMA and EBA on undue short-term pressure from the financial sector on corporations.

The European Parliament also endorsed legislation relating to a capital markets union in April 2019, which included regulations on disclosures relating to sustainable investments and sustainability risks.



Challenges

Despite the progress and the focus of governments, regulators and private businesses there are real challenges. Confusion around terminology remains and it is unclear whether the classification system being developed by the EU will be sufficient to address the issues facing this sector. Further clarity (which will need to find its way into law and regulation) is needed and consistency and alignment are required across asset classes and existing market-based practices.

Some of course are calling for a more radical approach. In particular, there is concern about in-grained short termism which may be incompatible with the long-termism required in order to achieve the goals behind the EU Action plan. That in turn may require an far greater alignment of financial and non-financial value creation-ideally across all asset classes (including conventional assets). Arguably that requires a radical adjustment of the traditional free market, profit-driven business model. Critics have asserted that the EU Action plan and TEG reports still leave investments open for "green-washing" leaving any identified underlying environmental concerns "un-impacted".

Conclusion

Impact Financing is becoming not just a matter of conviction but also a question of strategy and great strides have been made over the course of the last few years. Looking ahead, law, regulation, policy and practice and market recommendations on a national level and EU level look set to increase. This, combined with the continued shift in stakeholder demand and development of an impact financing eco-system, is likely to continue to challenge investors and financial institutions. Many investors and financial institutions have publicly committed to international goals and policies and as a result already sharpened their focus on the challenges arising from the impact financing sector. However, as Mark Carney has indicated:

> *"...the task is large, the window of opportunity is short and the stakes are existential."*

As a result of increasing legal and policy measures at an EU land national level, investors and financial institutions will continue to be required to assess, monitor, disclose and report the sustainability of their activities and the climate change risks posed to their business in preparation for these upcoming requirements. Increasingly, financial institutions may be judged by their sustainability strategy. How well do they manage the integration of ESG considerations into their investment decisions and deal cycles and into their approach to risk; and how good are their disclosure methodologies?

Dr. Richard Reimer
Partner, Frankfurt
T +49 69 962 36 414
richard.reimer@hoganlovells.com

Andrew Carey
Partner, London
T +44 20 7296 5949
andrew.carey@hoganlovells.com

Sukhvir Basran
Counsel, London
T +44 20 7296 2506
sukhvir.basran@hoganlovells.com

Sarah Wrage
Senior Associate, Frankfurt
T +49 69 962 36 421
sarah.wrage@hoganlovells.com

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> *Final Report 2018, EU High-Level Expert Group on Sustainable Finance.*