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The EU Sustainable Finance Action Plan

What you need to know and our expert view on the current four key initiatives

Introduction

Announced in March last year, the European Union's Sustainable Finance Action Plan is a major development as it moves sustainability deep into the core activities of financial institutions, such as banks, pension funds, insurers, asset managers and private banks, and the companies in which they invest.

The plan supports the EU's efforts to meet its climate and energy commitments under the Paris agreement.[1] As well as helping to manage risks around climate change, it should also encourage capital flows into areas that promote the United Nations' Sustainable Development Goals.

A Technical Expert Group (TEG) has been established that will operate until June, with a possible extension to the end of this year. Of the ten points in the plan, shown in Figure 1, the TEG is prioritising four. They are:

- (i) Developing an EU taxonomy
- (ii) Creating an EU green bond standard
- (iii) Transparency for sustainability benchmarks
- (iv) Improved sustainability disclosures

The TEG has assigned each of these a working group and we explain the four in detail in this paper, together with our take on what has been proposed so far.

One of the most urgent tasks is a robust classification and labelling system for sustainable investments green finance. So-called green washing is a growing problem that potentially undermines the whole industry. An agreed taxonomy would bring much-needed consistency and harmonisation to definitions and help build trust.

We also support the intention to adopt climate-related benchmarks, a huge area of interest to our clients. But we do worry that only focusing on low carbon and positive carbon impact indices does not reflect advances in physical climate risk analysis nor represents the diversity of investor views and risk/return expectations.

Improved disclosures is another big leap forward. DWS applauds the plan to require institutional asset managers to show exactly how their investments are aligned with their stated sustainability objectives. Indeed, we hope that the Action Plan will encourage greater clarity on the duties of all investors as they relate to environmental, social, and governance factors.

This in turn should drive efforts to integrate ESG into investment processes. As a result, clients will benefit not only from a more liquid pool of sustainable products but also from the increased pressure on companies to improve their sustainability reporting.

Indeed corporate disclosure has its own working group under the Action Plan and we cannot stress enough the importance of this initiative. Woeful levels of ESG-related information, particularly around climate risks, must be addressed and poses a real risk for investors.

On the following page we give a brief summary of events leading up to the Action Plan, next steps, as well as the timeline around the four working groups (Figure 2). For a more detailed description of the plan and its genesis, please turn to the appendix on page 15.

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[1] In November 2018, the European Commission approved legislation to increase the renewables 2030 target from 27% to 32%

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The origins of the EU Action Plan announced earlier this year date back to late 2016 and the establishment of the EU High Level Expert Group (HLEG) on sustainable finance. A year later, the HLEG presented its recommendations to the European Commission as to how sustainability could be integrated into the financial system. The commission announced its ten point Action Plan on Sustainable Finance last March (Figure 1) and less than three months later a Technical Expert Group (TEG) was established to move the commission's plan forward.

FIGURE 1. THE COMMISSION'S TEN POINT ACTION PLAN ON FINANCING SUSTAINABLE GROWTH

Source: European Commission (March 2018). Action Plan: Financing Sustainable Growth

The TEG has been charged with four main tasks, which fall under Actions 1, 2, 5 and 9 above, and relate to classifications, standards, benchmarks and disclosure (Figure 2). At the end of last year, TEG published its consultation strategy on taxonomy. For green bonds, consultations are taking place until March. Regaing low carbon benchmarks, workshops were organised between November 2018 and January this year with asset managers, retail investors, carbon data experts and benchmark providers with the aim of publishing an interim report by February. Finally, a report examining the metrics as they relate to climate-related disclosure, which will update existing non-financial reporting disclosure requirements, was just published in January.

FIGURE 2. THE ACTIVITIES AND TIMELINE OF THE TECHNICAL EXPERT GROUP

	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19
1. Taxonomy									
Open Consultation			Open consultation on High Confidence ("first round") mitigaiton activities Open consultation on the usability of the taxonomy in practice ("fit for purpose test")						
Open call for experts			Call for experts for the development of technical sceening criteria for second round mitigation and adaptation activities						
2. Green Bond Standard									
Targeted consultation		Consult Green Bond issuers, external reviewers, investors and relevant expert professionals active in the green bond market							
Open consultation						Broad stakeholder consultation			
3. Benchmarks									
Targeted consultation	Designing minimum requirements for the methodology of low-carbon and positive carbon impac benchmarks, consulting the following groups: (i) Asset owners (ii) Data providers (iii) Asset Managers and Index Providers								
Open consultation						Stakeholder cosultation on the interim report			
4. Disclosures									
Targeted consultation			Consultations with stakholders via webinars/conference calls and/or physical meetings						
Open consultation	Open stakeholder meeting								

Source: European Commission (December 2018). EU Strategy on Sustainable Finance and the Role of the Technical Expert Group

Taxonomy working group

Background

- The objective is a unified EU classification system on whether or not an economic activity qualifies as being environmentally sustainable for investment purposes. The latter is defined as an activity that must contribute to one of the six EU environmental objectives*. In addition, the activity must not do significant harm to any of the other five EU environmental objectives.

- The working group will start with the environmental objectives of climate change mitigation followed by climate change adaption. By 2022, the taxonomy will also cover sustainable use and protection of water and marine resources; transition to a circular economy, waste prevention and recycling; pollution prevention and control; and protection of healthy ecosystems.

- Using the NACE classification system, the working group has identified priority sectors, initially based on GHG emissions as well as mitigation potential. This covers: agriculture, forestry and fishing, power generation, manufacturing, transportation, contribution and real estate. Within these sectors, the metrics, principles, and thresholds of 25 economic activities have been identified for consultation.

- The taxonomy will be used by regulators at a national and EU level, for example in labelling schemes and for verifying claims that financial products are environmental sustainable. It will also aid the measurement of capital flows into environmentally sustainable activities and provide clarity as to the scale and scope of investments that are required to meet the EU's energy and climate targets for 2030.

Our view

- The sustainability taxonomy should help to bring much-needed consistency and harmonisation in green and sustainability definitions. It will become embedded in EU legislation and will be the basis for standards, labels, possible green-supporting factors for prudential requirements and measuring sustainable finance flows. We agree with the EU that its taxonomy will set a standard for the evolution of other taxonomies around the world.

- The taxonomy will take into account existing market practices – for example the Green Bond Principles, the Climate Bonds Initiative, the China Green Bonds Endorsed Project Catalogue and the FTSE Environmental Markets Classification System. A draft taxonomy was published by the TEG in December last year for consultation[1].
- An increasing number of our clients wish to invest in the low carbon transition as well as to address the broader financial risks surrounding climate change. Typically this has focused on selling companies with involvement in fossil fuel activities, most notably coal, and raising exposure to renewable energy and green infrastructure. However, there has been no standard approach to defining what can be classified as environmentally sustainable from an investment perspective.
- We also welcome a more robust taxonomy to address concerns of green-washing. The challenge will be to classify what are green activities in a robust fashion. The definition of nuclear will be particularly challenging given different views on this technology. We understand that such challenges may mean the taxonomy's progress into legislation will be somewhat slower than originally expected.

- We believe the taxonomy may also be used by banks in terms of screening their lending activities as well as by corporates to identify the range of their products and services that can be classified as green.

[1] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-feedback-and-workshops_en.pdf

- In any event, the taxonomy will help support efforts to provide clarity as to what can be considered environmentally sustainable and to channel investments into the correct activities that contribute to the low carbon economy and support the Paris climate agreement goals.

- It is crucial that the taxonomy is developed in a way to ensure that the governance and scope is robust to allow stakeholders to rely on the taxonomy while at the same time appropriately flexible to allow for adapting to changing developments in the market.

- As highlighted by the TEG, the taxonomy could affect the risk assessment of stranded assets even though the taxonomy is focused on environmentally sustainable activities rather than polluting activities.

- Given the staggered approach to build a taxonomy across the E, S and G of sustainable investing, we believe the application of regulatory requirements based on the taxonomy should be voluntary. It will not be until 2021 (and subsequently every three years thereafter) that it will be considered whether a taxonomy can be extended to sustainability objectives within S and G.

** (1) Climate change mitigation (2) Climate change adaptation (3) Sustainable use and protection of water and marine resources (4) Transition to a circular economy, waste prevention and recycling (5) Pollution prevention and control (6) Protection of healthy ecosystems*

EU green bond standard working group

Background

- The TEG aims to publish an EU Green Bond Standard (GBS) report by the second quarter of 2019. It will provide guidance for all relevant sectors, steps and actors. The report will also assess the impact of such a standard on the development of the green bond market.

- It will also feed into the work being launched in parallel by the commission on a potential EU Ecolabel for green financial products. In addition, the report will elaborate on possible incentives to enhance the growth of green bond issuance and the links with other green financing instruments.

- Since the green bond market's inception just over ten years ago, there have been increasing efforts to ensure the integrity of the market. These include measures to deliver more robust procedures to avoid claims of green-washing, to ensure that only eligible green projects are financed and that there are measurable and clear environmental and/or climate benefits.

- These concerns have arisen due to question marks over some issuers of green bonds, claims of fungibility and whether proceeds are going directly towards environmental projects. One example of the challenges around labelling is a May 2017 bond by Repsol, a global energy company, to help finance energy efficiency improvements in its petroleum and petro-chemical refineries.

- The International Capital Market Association's Green Bonds Principles (GBP), developed in 2014, are one of many initiatives that aim to improve the transparency and structure to the green bond market. The GBP are a set of voluntary guidelines that provide guidance on the key components involved in launching a reputable green bond. They also aid investors by promoting availability of information necessary to evaluate the environmental impact of their green bond investments as well as assisting underwriters by moving the market towards expected disclosures that will facilitate transactions.

- Guidelines and principles for green bond issuance have also developed at a country level, for example in China, Brazil, Kenya, Nigeria, India and Japan. While some of these guidelines have drawn on the expertise of the ICMA's Green Bond Principles, there have also been increasing attempts to coordinate across countries and regions with the aim of establishing international best practice. The ASEAN Green Bond Standards (AGBS), collaborating with the ICMA's GBP, is one example.

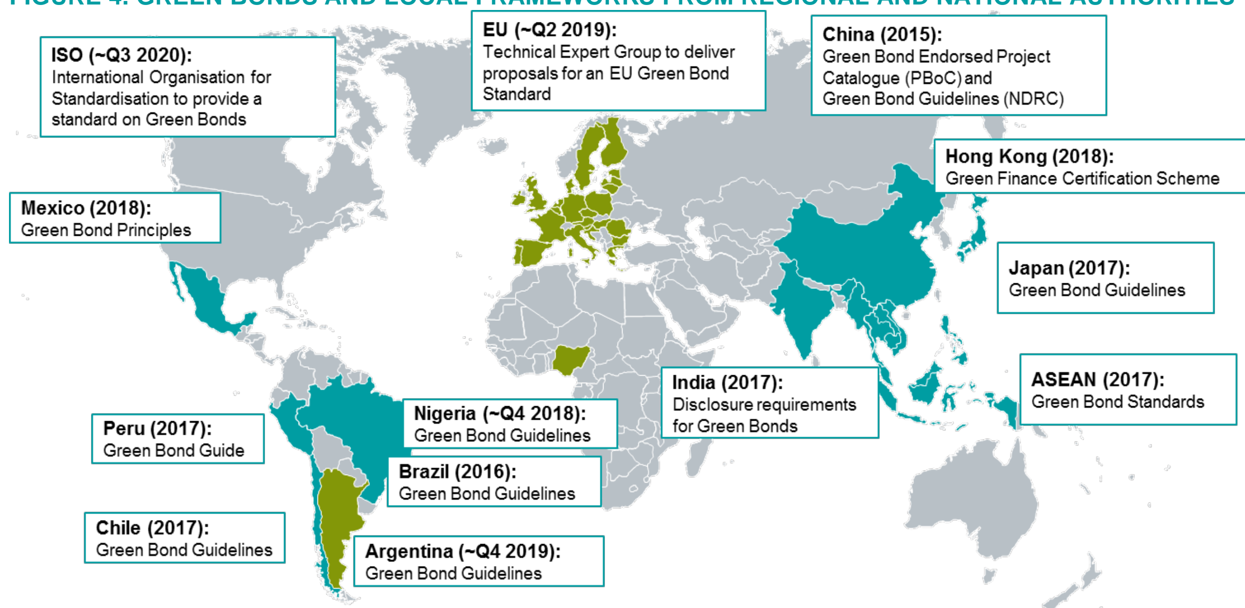
- However, challenges remain in terms of what can be classified as green across jurisdictions and whether, for example, these should be different classifications of green projects according to a country's economic development. Thankfully, we are seeing increasing global cooperation to standardise and formulate taxonomies as they relate to green bonds, most notably between the EU and China where the EIB and the Peoples' Bank of China have partnered to look at harmonising green bond guidelines.

- In the Action Plan, the commission will develop an EU Green Bond Standard, which would help to monitor, evaluate and verify the environmental impact of green bonds. The aim will be to assess the degree to which green bonds are providing additional capital to green projects and activities to ensure that existing investments are not simply being re-labelled green.

- Figure 4 shows examples of regional and national green bond frameworks. For example, the International Organisation for Standardisation (ISO) is currently working on a standard for green bonds and a framework and principles for assessing and reporting investments and financing activities related to climate change. For green bonds, this will specify eligibility requirements and define procedures for evaluating the environmental performance of green bonds. The standard will also define requirements for green bonds monitoring and disclosure and provides guidance on assurance methods.
- In March 2018, the 2°ii think-tank published a paper that assessed the benefits of the green bond market. It concluded that evidence is lacking to show that "use of proceeds" green bonds (95 per cent of the market) actually contribute to scaling up investments in green projects. To address these concerns, 2°ii suggest a series of actions to improve the green bond market's integrity, shown below.

- **Develop an advanced taxonomy of green projects:** Instead of relying on taxonomies of projects that are/are not green (and thus eligible to be included in a green bond), a more advanced taxonomy could offer 'shades of green'.
- **Improve green bond impact measurement indicators:** Green bond issuers are publishing reports, but are using a wide variety of indicators. Companies would do better to build on the Climate Bonds Initiative sector specific standards to show how green bonds contribute to the scaling up investment in green projects.
- **Advanced labelling system:** Some investors are already distinguishing between different types of green bonds, and new reporting indicators could accelerate this trend.
- **Potential policy incentives for green bonds could account for the above actions:** As the EU debates the potential for a change in capital requirements or incentive for green assets (a 'green supporting factor'), there should be some assurance of real world benefits.

FIGURE 4. GREEN BONDS AND LOCAL FRAMEWORKS FROM REGIONAL AND NATIONAL AUTHORITIES



Source: Environmental Finance (non-exhaustive list) (October 2018)

Our view

- We support the creation of an EU Green Bond Standard and note the positive results of China's green bond standard leading to rapid growth in issuance. Likewise, we encourage the EU to drive international harmonisation (particularly with China) towards an environmentally robust GBS.
- That said, the creation of a GBS is a necessary but insufficient action to expand green bond issuance. Strong economic incentives and regulations are also essential for green investment. Therefore state finance ministers need to encourage the rapid implementation of the new EU clean energy package.
- The GBS should encourage companies to issue green bonds, even if their business models are not fully sustainable. Issuing a green bond can create a positive feedback loop with investors, employees and other issuers that helps encourage a company to make broader and stronger sustainable commitments.
- We do not think the GBS will resolve the concerns of some stakeholders regarding whether additional green capex is occurring. In this regard, the 2 Degrees Investing Initiative and UNFCCC are developing

a framework to identify, assess, monitor and report how financial institutions' actions, such as investing in green bonds or using shareholder influence with companies, contributes to emission reductions.

- Likewise, DWS hosted a workshop in June 2018 to encourage the development of this framework. The aim was to develop specific guidance for assessing how an action such as investing in green bonds affects issuers' activities, which in turn affects the level of emissions in society.
- Our recent report on green bonds[2] suggested that to encourage issues linked to energy efficiency in buildings, the EU and market actors should encourage more banks to participate in the Energy Efficient Mortgages Initiative (currently 40 banks participate) and to issue energy efficiency linked green bonds.
- We believe that energy efficiency has a risk mitigation effect for banks as a result of its impact on a borrower's ability to service their loan and on the value of the property. Regulators should assess whether energy efficient mortgages represent a lower risk on the balance sheet of banks and could, therefore, qualify for a better capital cost regulatory treatment (a green supporting factor).
- The GBS is aimed at increasing European issuance, however, in our view, the EU should also consider how more capacity building efforts through aid and development bank activities in emerging markets can improve green bond policy frameworks, including energy efficient mortgages and bonds.
- DWS can help. Our ESG Engine can assess the 'greeness' of bonds that finance specific ESG related projects. This predominantly covers green bonds, but aims as well to cover sustainability or ESG themed bonds such as blue bonds, social bonds and sustainability bonds. The Engine uses a multi-stage process. First, a trusted third party conducts due diligence. For example ISS-oekom focuses on an issuer's ESG rating, potential controversies and verifies if the Green Bond Principles are respected. ISS-oekom also evaluates the environmental and social benefits of each project category and the eligibility criteria the issuer has chosen for identifying the projects to be financed.
- Second, any bond ISS-oekom designates as green is then judged whether or not it is compliant with our internal Minimum Environmental Social and Governance Standards (MSESG). That means the issuer must have a ESG_SynRating of A, B C or D. Low scoring issuers are disqualified. SynRatings measure an issuer's ESG quality and are based on data provided by ISS-oekom, MSCI and Sustainalytics.
- The third and final step arrives at DWS's green bond rating/green bond verdict – from A to F. It requires that the necessary technical green bond conditions apply, for example compliance with the Green Bond Principles. We also carry out broader ESG quality checks to ensure the issuer does not have severe norm compliance issues. As of 2017, Oekom's Sustainability Bond Rating covered approximately half of green bond issuances. For bonds where no green bond rating is available, if there is sufficient evidence that it would constitute a green bond, for example if it is a constituent of an index, a case by case defaulting is applied until dedicated evidence becomes available. This approach circumvents the challenges from still low coverage by third party data providers in the green bond rating space.

Sustainability benchmarks working group

Background

- The TEG is currently preparing a report on minimum standards for the methodology of low-carbon and positive carbon impact benchmarks. The interim report will be published by the end of February 2019.

[2] DWS (November 2018). Green bonds explained

- The working group is acquiring additional expertise and market feedback on its work with major asset owners, asset managers and retail investors as well as index providers and climate change experts. This included a workshop in December to ensure that any methodology reflected the expectations and strategies of asset managers.

- There has been some criticism of the EU Commission's original proposal with one MEP recommending new classifications to help investors transition to Paris-aligned portfolios, calling for all indices to be two degrees celcius compliant by 2022 – and for ESG disclosure for conventional benchmarks.

Our view

- DWS supports the intention of the EU to adopt climate-related benchmarks. However, we worry that the original proposal to introduce only low-carbon and positive carbon impact benchmarks does not reflect the rapid growth of different ESG and climate data and index methodologies nor the broad diversity of investor views and risk/return expectations.

- Data capture also remains a challenge. We support standardising metrics, such as the calculation of carbon dioxide emissions to facilitate comparability, as well as incorporating more forward looking metrics. Alignment with the Task Force on Climate-related Disclosure would also be helpful.

- Last year DWS launched a series of regional passive investment funds that combine ESG and low-carbon data. This is a good starting point for asset owners new to responsible investing but recognise that carbon footprint data is an imperfect measure of climate risk for several different reasons (Figure 5).

FIGURE 5. CARBON FOOTPRINTING IS A POOR PROXY FOR CLIMATE RISK

Shortcomings	
	Disclosure risk o Inconsistent company disclosure with limited data verification o Low reporting of scope 3 (supply chain or 'in-use') emissions, o Scope 3 methodologies are still under development in some sectors o Disclosure bias towards large caps and developed markets
	Measurement risk o Reliance on estimation by data vendors to fill data gaps (low comparability) o No agreement on which methodology to use (different results from different ways to calculate a portfolio foot-print or intensity)
	Materiality risk o Carbon intensity is not a risk metric at portfolio, sector or company level
	Strategy: no information on corporate strategy **Avoided emissions:** no accounting for companies creating green products **Time horizon:** point in time footprint does not capture changes in company exposure, emission reduction efforts, acquisition/disposal of facilities **Asset class:** Generally only focused on equities, there are differences in view of how a company's bonds/loans should be treated

Source: 2 Dii (March 2017); Bank of England (September 2015). Breaking the Tragedy of the Horizon – climate change and financial stability; Mercer 2016, IGCC 2017, DWS analysis 2017

- Another concern is that if a carbon footprint related investment methodology were to become the EU default climate benchmark, this risks sending the wrong signal to companies and also to investors. It might threaten to stifle investor innovation from data providers, investors and index calculation agents.

- We believe the concept of Paris Agreement/2 Degree Aligned investment funds is potentially a better concept. But we caution there are significant pros and cons to the 2 Degree Investing Initiative that pioneered the thinking in this area, Figure 6. In fact, there are multiple climate-related methodologies in the market that all have advantages and disadvantages.

- For example, it is possible to combine different ESG and climate methodologies – such as tilting investment portfolios to highly rated ESG companies with low carbon emissions. The next generation of investment funds will use a much deeper data set, utilising transition risk data and also physical climate risk data.

- Investors also have multiple motivations that need to be taken into account. Some may want to avoid financial risk and therefore be comfortable with investing in some fossil fuel companies. Others may be more environmentally or socially focused and want to exclude fossil fuel companies.

- This is why we remain cautious on whether currently it would be possible to reach an agreement on the 'best' climate methodology within the investment world, let alone within the EU policy making process.

- In creating any sort of climate or ESG related equity fund or benchmark, the EU and investors must be clear with clients and the broader public that this does not necessarily lead to 'real economy' change.

FIGURE 6. PROS AND CONS OF THE 2 DEGREE PORTFOLIO ALIGNMENT METHODOLOGY

Pros	Cons
Forward looking nature of the assessment	An emerging data source that may need additional due diligence (such as on the historical accuracy of underlying data providers' Capex forecasts)
Based on facility (asset) level data – a significant data innovation	Limited sector coverage (energy/carbon intensive sectors could represent ~22% of a portfolio's value)
Of a typical portfolio's 'owned' carbon emissions, sector specific analysis (oil, gas, coal, power, auto, aviation, shipping, steel & cement) covers 50-70% of scope 1 emissions and 80-90% of scope 2 emissions	No coverage of physical climate risk, but the underlying data could be used for physical risk analysis in future
The 2 Degrees Investing Initiative think tank has used the methodology with financial regulators (such as the California Insurance Commission), prompting many more financial institutions to consider climate risk exposure and management	Does not analyse the strength or quality of companies' climate risk management strategies
Based on International Energy Agency (IEA) scenarios – an accepted global standard, with scenarios from other organisations being added	IEA has a relatively poor track record of predicating renewable energy growth.
Started to develop a commercial data offering as a for-profit spin-off of 2 Degrees Investing Initiative that will re-invest/re-grant all profits.	No assessment of the probability of the IEA scenario coming true – there are many potential future energy technology deployment scenarios
	IEA's 2017 'Sustainable Development Scenario' may only provide a 50% chance of meeting the Paris Agreement goal – according to analysis by an NGO and an energy research institute

Source: DWS October 2018 analysis of 2 Degrees Investing Initiative. Oil Change International and Institute for Energy Economics and Financial Analysis, April 2018. For illustrative purposes only.

- Tilting a portfolio away from companies with high carbon emissions may reduce financial risk for a pension fund if those companies' profitability falls due to regulations and faster expansion of renewable technologies. However, shifting stock ownership/divestment does not affect carbon emissions, real world resilience to physical climate impacts or change other factors such as companies' treatment of workers or gender diversity (Figure 7).

- Benchmarking is to be encouraged, however fund managers must use their investor influence with companies to improve practices and policies too. DWS recently published a report where this point was

explained in more detail.[3] And to this end we have the strongest track record in the US voting in favour of climate-related shareholder resolutions at companies.

- Therefore the EU also needs to consider how to encourage stronger engagement activities and also government policy advocacy by asset owners and asset managers alongside any climate-related benchmarks.

FIGURE 7. ANALYSIS OF THE INDIRECT INFLUENCE OF RESPONSIBLE INVESTMENT STRATEGIES

Indirect investment impacts				
Strategy	**Exclusion**	**Best in Class**	**ESG/climate Integration**	**Active ownership**
Mechanism of influence	Signal to society that excluded industry is illegitimate	Brand value of industry leaders leads to reputational incentives on other companies to improve	Increased demand for ESG data leads to better company management systems	Communicate shareholder demands directly to management *(AGM resolutions)* Investors do more to encourage governments to adopt policies supportive of long-term growth and sustainability
Potential investment impact	Political reform restricting the excluded industry	Potential industry wide improvement of ESG performance	Potential industry wide ESG performance improvement	Target improvements in ESG performance of investees. Influence government policies
Only if investor…	Make exclusion decisions public	Investment increases credibility of fund / index	Insists on high quality corporate disclosure	Pursues realistic change at the right targets. Removes first mover disadvantage by sector wide and public policy focus
Critical catalyst	Political movement or societal shift resulting in tangible impact	Companies actively improve ESG performance to become ESG leaders	Company managers act on the reported data and pursue improvement targets	Asset owner demands / requirements
Uncertainty of impact on the real economy	**High**	**High**	**High**	**Low**

Source: Preventable Surprises (June 2018); DWS analysis November 2018

Climate-related disclosures working group

Background

- The TEG's work on disclosures is an extension of the commission's non-binding guidelines on non-financial disclosure. Its report addresses climate-related disclosures only and applies to certain large companies with more than 500 employees, with some countries applying the rules to companies of 250 or more employees.

[3] DWS (November 2018). Experts on Climate Change

- Published at the beginning of this year, the TEG report goes further than the recommendations of the TCFD. In addition to proposing disclosures examining how the performance of a company is likely to be affected by the physical effects of climate change and the transition to a low carbon economy, it also includes how the activities of a company itself impacts climate change.

- Disclosure proposals include publishing direct and indirect GHG emissions in line with GHG Protocol methodology or the ISO 14064-1:2006 standard as well as targets for GHG emissions in absolute terms and intensity, for example relative to turnover. Companies much disclose energy consumption from renewable and non-renewable sources too. Supplementary KPIs have also been proposed, for example, assets committed in regions exposed to increased risks of extreme weather events.

- In June 2019, and based on the TEG's proposals and subsequent market feedback, the commission will publish its own updated guidelines on non-financial disclosures, which will include the climate-related metrics developed under the new classification system.

- The TCFD has stated that many companies describe climate-related risks and opportunities, but few disclose the financial impact of climate change on their company. Disclosures also varied across sectors, with more non-financials reporting climate-related metrics and targets than financial companies. In addition, only a minority of firms disclosed forward-looking climate targets or the resilience of their strategies under different climate-related scenarios, including a two degrees or lower temperature limit.

Our view

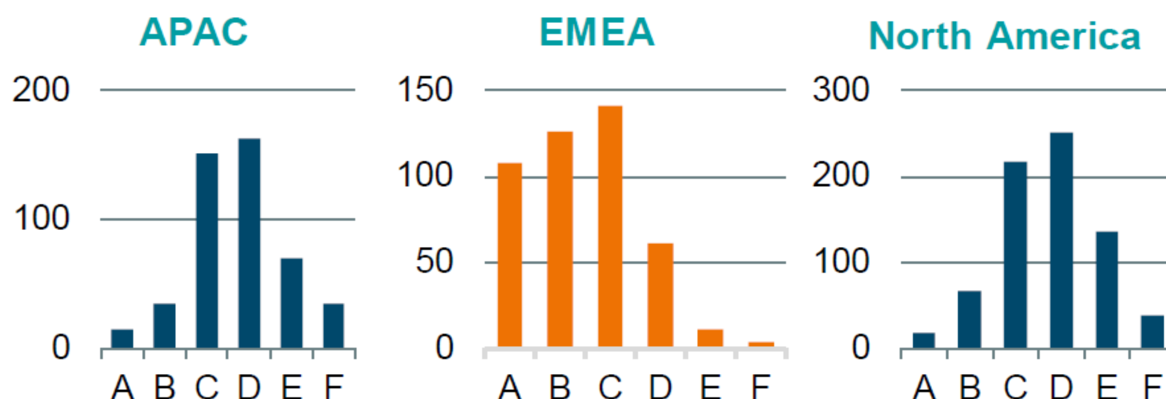
- In research published in September 2018, we found that ESG disclosure has the weakest correlation to corporate financial performance[4]. The limited standardisation of ESG disclosure practices simply encourages companies to provide primarily beneficial rather than unbiased ESG information.

- Our analysis also showed that poor disclosure information can lead to biases in ESG ratings. For example, while the geographical distribution of ESG ratings in Figure 8 reveals a similar pattern for APAC and North America, it shows a significant tilt towards higher ESG ratings in Europe. This may be due to mandatory ESG disclosures in some European countries and the more advanced stage of responsible investing. The implication of this finding is that investors who aim to increase the overall ESG rating of a global portfolio will find their holdings naturally tilt towards European companies[5].

- One way of overcoming such data limitations can be to strengthen efforts towards a more stringent and maybe even mandatory extra-financial data disclosure. Standardisation efforts of the Sustainable Accounting Standards Board, the EU's Action Plan and the Taskforce on Climate-related Financial Disclosure are therefore welcome developments from an investor perspective.

[4] DWS (September 2018). ESG and Corporate Financial Performance: Digging Deeper
[5] DWS (October 2018). The quant road to ESG investing

FIGURE 8. ESG RATING DISTRIBUTION BY MSCI REGIONS



Source: DWS (end April 2018)

- We believe that investors need to be able to assess the financial risk for any given company. However there is currently a lack of granular and accessible information regarding physical climate change. For example, how important is any given factory or warehouse is to an overall company's profitability? Are they exposed to sea level rise?' To answer these questions requires not only climate data but ancillary information such as whether production can be shifted quickly.

- In addition, we need more disclosure from companies on the cost of risk mitigation. Then investors can assess the measures taken to improve resilience or advice on the most efficient ways to respond to risks. Also of interest is the level of insurance cover and confirmation money will actually be paid in the event of climate-related damage.

- Hence DWS welcomes efforts to improve climate-related disclosures of companies and financial institutions. We believe such disclosures should become mandatory as there are still too many companies that do not disclose even the simplest ESG metrics, such as carbon emissions.

- We agree that revising EU ESG/climate disclosure frameworks to account for TCFD should both challenge and support leading companies to go further. However regulators need to support companies that have disclosed extra-financial information in 2018 for the first time.

- DWS chaired one of three working groups that gathered together financial institutions to make 18 recommendations on how corporates should disclose their risks and opportunities from physical climate risk. The report "Advancing TCFD guidance on physical climate risks and opportunities" was supported by EBRD and the Global Center on Adaptation[6]. We therefore encourage policy makers and other stakeholders to integrate these recommendations into EU disclosure rules and guidelines.

- One framework that inspires the physical risk disclosure guidelines is for companies to apply insurance sector metrics of annual, one in 20 year, one in 100 year, and one in 200 year values at risk from extreme weather event disruption to operations, production, suppliers, customers and markets.

- If the EU were to add disclosure of physical risks and opportunities to EU policy frameworks, this could be an important action announcement at the UNSG summit in 2019, linked to the Global Commission on Adaptation, led by Ban Ki Moon, Bill Gates and head of the World Bank. As a starting point, companies should identify historical impacts of extreme weather events such as days of business interruptions and associated costs.

[6] Available at: www.physicalclimaterisk.com

- Twenty years ago, leading companies worked with experts to establish the global rule book for how carbon emissions should be measured in different sectors – the GHG Protocol. We now need Physical Climate Risk and Opportunity Protocols across all major sectors in order to create momentum towards improved resilience to physical climate risk.

- Likewise a parallel initiative along the lines of 'Resilient Companies and Supply Chains' is desirable. Over the last several years the 100 Resilience Cities initiative has been helping cities around the world create resilience strategies. More companies are signing up to the RE100 initiative and to science-based emission reduction targets.

- Instead of a naming and shaming approach, we believe it is preferable to create a badge of honour that is valued by investors, banks, rating agencies and by companies themselves. Sector based disclosure protocols would be one element of a Resilient Companies initiative, but it should also include how companies are helping protect their workers and local communities.

- Ultimately, a grand coalition of academics, governments, companies, investors, rating agencies, banks, and specialised data providers may be required to improve resilience. It may take cooperation and investment in protective infrastructure, on reinforcing wetlands and coastal areas, both in terms of data, disclosure and in terms of physical resilience.

- Improved disclosure is necessary to more precisely assess potential value at risk and business opportunities. One role for investors is to prod companies to better disclose their risks, but also encourage them to improve the resilience of their operations, supply chains and communities where they are located. Investors and society still suffer if a factory is safe from flooding while workers' homes are destroyed. Companies need to become anchors for improved community resilience.

Appendix: Details on the EU Action Plan

The EU Action plan will enter the core activities of financial institutions such as banks, pension funds, insurers, asset managers and private banks.

For example, the commission has proposed a harmonised EU approach to the integration of ESG risks and opportunities into fiduciary duties of financial institutions. The proposed rules cover all financial products offered and services provided by the below mentioned entities regardless of whether they pursue sustainability investment objectives or not. The regulation will apply to:

(i) Asset managers, regulated under UCITS, AIFMD
(ii) Insurance undertakings regulated by Solvency II
(iii) Occupational pension funds regulated by IORP II
(iv) Insurance distributors regulated by the Insurance Distribution Directive (IDD)
(v) Investment advisors and individual portfolio managers regulated by MiFID II

Delegated acts to amend MiFID II and IDD are taking place that will ensure investment firms and insurance distributors take sustainability issues into account when providing investment advice to their clients. Up until now, when providing a sustainability assessment this has typically focused on the time the client wishes to hold the investment, the client's risk profile, the purpose of the investment…etc.

The amendments will mean that sustainability and ESG preferences will need to be incorporated, such that non-financial preferences namely the environmental and social impacts of the investment will be included. Assessing ESG preferences will be gathered through a mandatory questionnaire. These would then need to be taken into account when offering financial products to a client. In addition, an investment firm will also have to prepare a report that explains how the recommendation meets his/her investment objective, risk profile, capacity for loss bearing and ESG preferences.

Similar amendments are proposed for investment intermediaries and insurance undertakings providing advice on insurance-based investment products under IDD. In terms of timing, these proposals can only be adopted once the sustainability taxonomy has been agreed upon. Once the taxonomy has been agreed, there will be a 12 month and 18 month transition period in terms of implementation for those regulated under MiFID II and IDD. Figure 3 provides an indication of the broad reach of proposed legislative and regulatory actions as they relate to the EU Action Plan.

The European Supervisory Authorities (ESAs) will also be required to incorporate ESG risks in their activities and include provisions on sustainability preferences in their guidelines on the suitability assessment. The ESAs are comprised of the European Insurance and Occupational Pensions Authority (EOIPA), the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA). By addressing clients' preferences towards ESG, this should result in investment advisers responding to ESG considerations and asset managers being incentivised to design suitable products. Both will help expand the pool of green investment products.

EIOPA is working on how ESG factors should be integrated into Solvency II. Unlike the approach in China, which has adjusted capital requirements in favour of green assets, the approach in Europe may be different whereby regulatory incentives to promote green finance, so called green supporting factors, are related more cautiously in order to prevent the risk of green asset bubbles forming. More likely is a framework that penalises brown activities, even though this is not explicitly the task of the EU taxonomy which is focused on identifying environmentally sustainable activities. More clarity on how policy in this area will evolve is expected from the European Banking Authority, who is tasked to publish its recommendations in this area within the next two years.

These initiatives complement many other sustainability efforts underway across the financial sector, for example the Network for Greening the Financial Systems (NGFS) established in December 2017. From an initial eight members, the network has grown to 19 central banks and supervisors. It aims to strengthen the global response to manage risks and mobilise capital for green and low-carbon investments. In 2016, the Sustainable Insurance Forum was established and brings together 20 of the world's largest insurance regulators to strengthen understanding of and responses to sustainability challenges.

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