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SUSTAINABLE FINANCE: WHAT IS THE ROLE OF THE REGULATOR? AMF ROADMAP

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AUTORITÉ DES MARCHÉS FINANCIERS

AMF

Message from the Chairman

The emergence of a financial model which better integrates sustainability issues is a necessity; it is in fact a vital challenge both for the planet and for finance. Financing needs to ensure the transition to an economic model that protects our environment are vast. If the financial industry does not demonstrate its usefulness in ensuring this transition it will

Fortunately, it now appears to be an underlying market trend at many levels, from firms to asset managers and investors.

The European Commission's proposals offer Europe a chance to establish an innovative and ambitious framework for sustainable finance, capable of addressing the risks and challenges identified. They must help to accelerate the transformation of the financial industry and to bring about real changes for all market participants. The future European framework must capitalise on the efforts that have already been made and the good practices that are being identified without restricting a market that is evolving and progressing rapidly.

The French market is ahead of practices abroad, which is due to the expertise on these subjects that has been developing in Paris for many years and the various initiatives taken as well as the advances of the French legislative and regulatory framework.

The regulator has an important role to play in supporting and encouraging this development, whilst ensuring that the conditions for confidence are preserved. The AMF's endeavour to promote sustainable finance is a strong commitment that will focus on several key priorities:

- supporting market participants and raising awareness in order to foster good practices;
- encouraging innovation in favour of sustainable finance;
- supervision to ensure in particular the relevance of the information given;
- collaborating with other regulators and participating in European and international work;
- educating savers.

Comments

Comments may be sent to the following email address: directiondelacommunication@amf-france.org

Legislators, governments, central bankers, asset managers, investors and firms have multiplied their announcements in support of sustainable finance over the past few months. Commitments have been undertaken and specific proposals have been made, notably with the publication last March of the European Commission's Action Plan on Financing Sustainable Growth. In France the PACTE draft law affirms the need for companies to consider the social and environmental issues inherent in their activities and defines the concept of a firm's corporate interest. Moreover the draft law also defines a specific task for the AMF, which is responsible for ensuring the quality of the information that management companies provide on their strategy and risk management in the face of climate change.

What about the market regulators? At the beginning of 2018 the AMF made sustainable finance one of its eight priorities for 2018 and a building block of its five-year vision, #Supervision2022. Although socially responsible investment (SRI) and corporate social and environmental responsibility (CSR) issues have already been the subject-matter of work by the AMF, the initiative is now construed more broadly, by "*integrating the objectives of sustainable finance into all the tasks and activities of the AMF*".

2010: first AMF report on corporate social and environmental responsibility
2015: first AMF report on socially responsible investment
2016: third AMF report on corporate, social, societal and environmental responsibility
2017: second AMF report on socially responsible investment
2017: The AMF commits to promoting sustainable finance on the occasion of Climate Finance Day
2018: Sustainable finance is identified as one of the AMF's eight priorities for action for 2018 and a building block of its five-year strategic plan, #Supervision2022

1. Some background information on the emergence of sustainable finance

Sustainable finance is a comprehensive approach aimed at strengthening the long-term social, economic and environmental performance of finance. This revolves around an objective of financial stability and taking greater account of social and environmental externalities together with long-term risks and opportunities. Sustainable finance also considers the financial sector's contribution to a more sustainable economic development model.

The political impetus in this area was marked by two major milestones at the end of 2015: on the one hand, the United Nations' adoption of Agenda 2030, accompanied by 17 Sustainable Development Goals (SDGs), and on the other, the signing of the Paris Agreement for a transition to a low-carbon economy, which refers, for the first time, to the role of financial services. Beyond these strong political initiatives, several developments in recent years have helped change perceptions and practices within the financial sector.

Accordingly,

- **Climate risk** is now clearly identified, through physical, transition or liability risks, as a risk for the financial sector and financial stability. At the same time, this risk seems to still be insufficiently taken into account by the markets and, although their proportion is increasing rapidly and varies from region to region, only a minority of institutional investors and asset managers consider it explicitly today.

- Besides climate risk, a growing consensus recognises that **environmental, social and governance (ESG) factors influence the performance** of investment portfolios directly, through their impact on companies' results (links between non-financial and financial performance, possible financial impact of ESG "incidents"), or indirectly, due to the risks that they pose to financial growth and stability.

- A growing number of studies show a **positive link between taking account of ESG factors and** portfolios' **long-term** risk-adjusted **performance** ("sustainability" premium), contrary to the suggestion that the latter would involve "giving up on performance". The available data also tends to show that divestment or exclusion strategies do not generally result in a performance "penalty", in spite of the impact on the diversification of the portfolios, even though deviations in terms of returns or tracking errors may be observed over the short term.

- The diversity of the strategies implemented, however, makes generalisation difficult: hence **strategies for integrating ESG factors and responsible investment vary significantly** from one player to another (application of ESG filters, best-in-class or best-in-universe strategies, exclusions, thematic funds, engagement, "impact" investments, etc.). The approaches taken and the resources allocated also remain very varied depending on the players, which may pursue very different objectives (management of the risks, alignment with ethical or social values, seeking performance or defined (social or environmental) objectives, as well as management of reputational risk).

Philippe Sourlas
Asset Management Directorate

The ISR reports of the AMF show the progress made by asset managers in recent years in the information they make available to clients, but also highlight certain areas where there is still much to do. Our daily task is also to accompany management companies who are increasingly developing innovative strategies for responsible investment.

- Institutional investors and asset managers face several **obstacles to integrate ESG factors** in their asset allocation and risk management processes. These obstacles may be related to a lack of expertise, a lack of reliable available data or analysis tools, or else a lack of internal consensus on the materiality of the risks and the link between ESG and performance within investors.

- Despite the difficulties encountered and the diversity of the approaches, the trend is a more widespread adoption of ESG factors by institutional investors; this trend is reflected in the increasing emergence of ESG themes in **discussions with analysts, presentations of results, annual general meetings** and board of directors meetings. Finally, it can be seen that a growing number of issuers are publishing integrated reports mixing financial and non-financial data, whose stated objective is to promote the vision and the long-term strategy of the firms. A number of firms are now also publishing information on their contribution to the UN's Sustainable Development Goals (SDGs).

For listed companies, integrating the issue of sustainability requires an awareness of their social and environmental responsibility, the expectations regarding their non-financial performance and the necessity to define a strategy vis-à-vis structural trends and medium-term issues, such as climate change and changes in society.

For asset managers, that involves a more widespread integration of social, environmental and governance criteria into their risk management and their investment strategies, as well as the development of offerings of responsible or "impact" investment strategies.

This trend also meets the ***growing expectations of investors***, both institutional and retail. It will facilitate the gradual implementation of financial tools for addressing future challenges, foremost among them responding to climate change and financing the energy transition.

- **Climate-related reporting** has been developing rapidly since the publication, in June 2017, of the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) set up by the Financial Stability Board, as well as under pressure from investors: these recommendations are built upon the obligations introduced in France in 2015 by Article 173 of the Law on Energy Transition and Green Growth, but go further, by encouraging the use of scenarios (principally the limitation of global warming to two degrees) to assess the resilience of strategies. A number of French issuers, investors and asset managers have already committed to implement these recommendations.

Article 173 of the Law on Energy Transition and Green Growth

The Law of 17 August 2015 introduces obligations for asset managers and investors to provide information about their management of climate-related risks, and more generally the integration of environmental, social and governance factors into their investment policy, without imposing a prescriptive method. Article 173 also extends corporates' obligations by strengthening the requirements for transparency on the risks and opportunities related to climate change and the measures taken to implement a low-carbon strategy.

- Even though progress can be observed, the **quality of the ESG data**, its comparability and its verification are major challenges, and the same applies to impact measures data. This data plays an important role in risk management systems, the selection of portfolios and the production of indices (such as low-carbon, climate and governance indices), in accordance with various methodologies. Furthermore **private standards** are also developing rapidly, notably in relation to climate-related reporting, green bonds, non-financial information in general and responsible investment, where questions may arise concerning the governance and available resources of the entities behind the development of these standards. They are supplemented by "coalitions" of corporates, charters or codes of good practice developed at domestic or international level, with varying requirement and commitment levels.

- The growing consensus on the need to move towards a sustainable finance model is reflected in **investment trends**, the ultimate challenge being the reallocation of financial flows in favour of a sustainable development model; for the climate change issue alone the European Commission puts the investment needed to achieve the objectives set by the Paris Agreement at 170 billion euros per year. The absolute figures, however, remain low and the exact amounts are difficult to assess, due in particular to differences in definition: there has been a rapid growth in global green bond issues in recent years, which, according to the definitions, should amount to 200 billion dollars in 2018, with France ranking third globally, but represent less than 3% of the global bond market. "Green" funds are also experiencing rapid growth in Europe (up 50% in 2017, making a total of 32 billion euros), but continue to be marginal (less than 0.3% of assets under management)[1].

Julien Laroche
Corporate Finance and Corporate Accounting Directorate

The key factor in the success of the green bond market is certainly the confidence of the various stakeholders. The information given to the investor about the use of the funds is essential. Although regulation does not specifically deal with these issues, we try to support the development of the market by contributing to the emergence of robust practices designed to address transparency issues whilst preserving sufficient agility at the launch of an operation. The proper functioning of this market under construction is the responsibility of all the players.

  - **Socially responsible investments (SRIs)** represent much more significant amounts but, as emphasised above, cover very different realities: a recent survey by the AFG (French Asset Management Association) in collaboration with the FIR (French Responsible Investment Forum) assesses global "responsible investment" (RI) assets under management in France as of the end of 2017 at 1,081 billion euros (excluding strategies based solely on exclusion), of which 310 billion euros are in SRIs (mainly best-in-

[1] Novethic, *Marché européen des fonds verts (European Green Funds Market)*, April 2018.

class) and 771 billion euros are in other ESG approaches. Assets under management of funds with an SRI label have also risen rapidly and currently exceed 46 billion euros, divided among 170 funds and 36 management companies.2 Moreover Novethic defines SRI "with conviction" as "*SRI funds marketed in France and available to a retail investor client base offering the portfolios that are most affected by the ESG assessment of their issuers*" (mainly thematic approaches and best-in-universe funds), assessed at 38 billion euros as of the end of June 2018.

- In addition to the rapid increase in "SRI" assets under management there are also signs of a **growing interest by retail investors** in socially responsible investments. In France figures from the FIR[3] indicate that six out of ten French investors say that they attach great importance to environmental and social impacts in their investment decisions. The public labels (SRI, TEEC, Crowdfunding for Green Growth, amongst others) strive to provide clarity for non-professional clients and to facilitate the development of the range of products on offer. This is also the aim of several proposals by the European Commission (taking account of clients' ESG preferences, development of labels).

- **Financial innovation** is also developing rapidly. It offers benefits in terms of differentiated responsible investment, risk management and financing strategies, but may also entail risks – particularly marketing risks – related to their complexity, transparency or cost; certain schemes may also raise new questions (carbon neutrality, etc.). In addition, without touching on the "greentech/cleantech" sectors, "**green" fintech** or "responsible" fintech is another emerging field, either through applying fintech models to sustainable finance issues (new forms of financing for sustainable projects, integration of ESG criteria into automated financial advisory services, etc.) or else by enabling the development of new solutions (enhanced traceability of investments and impacts via blockchain-based applications, use of artificial intelligence tools for analysing ESG information, etc.).

Investors' obligations and taking account of clients' preferences: proposals under discussion at European level that are going in the right direction

The European Commission's proposals, which are close to the provisions of Article 173 of the French Law on Energy Transition and Green Growth, provide for the obligation for market participants to publish their policy for integrating ESG risks into their investment process. This new obligation will help to strengthen the information provided to investors and it will have to be applied widely, not just to players promoting "responsible" strategies, whilst taking differences in strategy and in size into account.

The second part of the European Commission's proposals is aimed at a framework for sustainable investments, with the particular objective of avoiding "greenwashing". Besides products highlighting an investment's "contribution" to achieving ESG objectives, as the current proposals provide, the new European framework must also help to strengthen the comprehensibility of all "sustainable" strategies offered to investors and should therefore apply, from the AMF's point of view, to the various products marketed as such.

Lastly, taking account of clients' preferences in relation to ESG factors, which is envisaged by the European Commission, is an innovation compared to the French framework. It poses challenges at the operational level, but it can help responding to perceptible changes in clients' expectations and is a means of accelerating developments in the range of "sustainable" financial products.

- In this fast-changing environment, the **Paris financial marketplace**, grouped under the association "Finance for Tomorrow", has recognised strengths: commitment by the authorities, expertise in the non-financial

[2] SRI label data as of the end of October 2018. As of the end of November 2018, 22 funds had also received the TEEC label (*Transition Energétique et Ecologique pour le Climat* – Energy and Ecological Transition for the Climate).

[3] IFOP survey for Vigeo Eiris and the FIR, *Les Français et l'investissement responsable (French Investors and Responsible Investment)*, September 2018. In spite of this strong expectation, the survey emphasises that SRI is still infrequently offered to retail clients. In contrast, in the employee savings sector, data from the AFG as of the end of 2017 shows that SRI funds' assets under management represent more than a quarter of employee savings (excluding employee share ownership), which likely reflects the obligation to present a social or revenue-sharing fund in the range of funds offered to employees, often an SRI fund.

area, key players (arrangers, asset managers, issuers, agencies and service providers, etc.), academic research, labels, etc. Furthermore it benefits from a more advanced legislative and regulatory framework than in the rest of Europe.

2. A role for the regulator

From the point of view of the market regulators the subject of sustainable finance poses new challenges. In particular the large number of environmental, social and governance themes call on specific expertise and an understanding of global challenges (energy transition and changes in society, for example). In spite of calls from certain quarters[4], few regulators have yet invested this area, but are now starting to rally at the European and the international level.

The AMF has made sustainable finance a building block of its five-year vision, thereby recognising the underlying trend at play in the industry as well as the expectations of a growing number of stakeholders. Works had already been published, with a number of recommendations by the regulator vis-à-vis listed companies and asset managers as well as issuers of green bonds. The main priority was to foster the transparency of the information provided and to identify good practices. Expertise, however, had remained compartmentalised among a small number of individuals and the measurement of the challenges and impacts was still limited.

The guiding principles for the AMF's roadmap are based on the following findings:

- Sustainable finance is entering a **critical development phase**, with considerable financial and non-financial challenges. It is also a strong competitive asset for the Paris financial centre, which has recognised strengths in the area.

- The regulator has an important role to play in this development, both **to protect** and **to support**, and to preserve the conditions for confidence; this role must be clarified and highlighted.

- The regulator itself must evolve in order to **integrate this new dimension into its regulatory practice and its perception of the market**.

- At the same time, faced with the diversity of ESG issues (climate, biodiversity, water, pollution, human rights, working conditions, health, etc.), the jurisdiction and the tools of the regulator will by their very nature limit its involvement with regard to, for example, assessing the "greenness" or "sustainability" of an activity.

Work within ESMA

Of the ten initiatives proposed by the European Commission in its Action Plan for Sustainable Finance, eight have a direct impact on the operation of the markets and the entities regulated by the AMF. In connection with this the European Commission has mandated work within ESMA, relating in particular to the integration of ESG criteria into investment decisions, risk management and advice. A technical advice on these subjects is expected to be issued by ESMA on 30 April 2019, in coordination with EIOPA. Within the ESMA's Corporate Reporting Standing Committee (CRSC), the Narrative Disclosure Working Group deals with the subject of non-financial information with the objective of developing common supervisory approaches in Europe. Other work mandated by the European Commission will focus on the integration of ESG factors by rating agencies, low-carbon indices, non-financial research and ESG ratings as well as the impact of portfolio rotation.

[4] See the conclusions of the European High Level Expert Group (HLEG) on Sustainable Finance or the calls from certain NGOs, in particular.

3. AMF roadmap

The information set out above emphasises the complex and cross-disciplinary nature of the subject of sustainable finance. Accordingly the regulator's response must be based on **several pillars**.

> **Integrating sustainable finance objectives into the regulator's tasks and activities: five areas of action to facilitate transformation and preserve the conditions for confidence:**
> ❶ Supporting players and innovation
> ❷ Supervision and monitoring
> ❸ Participating in European regulatory work and collaborating with other regulators
> ❹ Educating savers
> ❺ Developing internal expertise and governance

The action by the AMF is coordinated, using a cross-disciplinary approach, by a ***Sustainable Finance Task Force***, which is responsible for implementing the roadmap.

❶ Supporting players and innovation

Although the structuring of the financial industry is swift, many market participants have not yet made much progress in their ESG practices. The objective of the regulator will be to **support developments and to raise awareness generally**, through the organisation of workshops, the sharing of good practices and the publication of guides and recommendations, without duplicating or pre-empting work that can be done by marketplace associations or international fora. A first series of workshops organised at the end of October 2018 has thus enabled exchanges about actual practices in relation to the integration of ESG factors at asset managers and institutional investors, the difficulties encountered and the outlook for development. As the work progresses, the AMF will also have the task of **explaining its expectations vis-à-vis players**, as it has done in the past with its SRI and CSR reports and for the issuers of green bonds, or, more recently, for the marketing of structured products linked to ESG-related indices.

Developments, such as taking account of clients' ESG preferences when giving advice and integrating ESG factors, may, moreover, have significant operational consequences for market intermediaries. It will be the AMF's responsibility to support these changes in order to facilitate the transition. Actions in the area of training and professional certification, for example, may support the efforts of the industry.

A second raft of measures concerns support for **innovation**, in collaboration with the AMF's FinTech, Innovation and Competitiveness team. As in the fintech sector, the objective is to facilitate the development of new solutions for sustainable finance, to identify the issues raised and the potential risks as well as any obstacles that could be eliminated or guidelines to be laid down.

❷ Supervision and monitoring

Supervision is an important aspect of our action to promote sustainable finance. It takes several forms: monitoring listed companies and investment service providers, on-site inspections, monitoring marketing campaigns and distribution.

In 2018 two main actions have been conducted in relation with **listed companies**: on the one hand, an examination of non-financial information provided by listed companies during the annual review of corporates' reference documents , and on the other hand, an analysis of recent trends in relation to the publication of integrated reports by issuers. Moreover 2018 is a year of transition, with the entry into force in France of the Directive on the Disclosure of Non-Financial Information. A new edition of the AMF's CSR report will update the findings made in 2016 based on the review of the new non-financial performance statements prepared by companies. Thematic studies, for example on climate-related reporting, will be planned over time.

Charles Descamps
Corporate Finance and
Corporate Accounting
Directorate

The AMF supports and guides issuers through the periodic review of published information. Our aim: the production of information that is clear, comparable and hence usable by investors, highlighting non-financial issues in a meaningful way. We have two concerns: greater integration of CSR issues in the presentation of the activities and the strategies of firms, and a balanced approach to the subjects.

In the area of asset management the AMF has taken a number of **measures to follow up on the findings of the SRI report** published at the end of 2017[5]. These concerned, in particular, reminding management companies of their disclosure requirements, which are defined, inter alia, by Article 173 of the Law on Energy Transition and Green Growth, and asking them to make the reports required by the provisions. The new information collected enabled the analysis presented in the 2017 report to be updated and will be used in the evaluation report prepared by the Directorate-General of the Treasury and the Office of the Commissioner-General for Sustainable Development. A series of short thematic inspections was also launched in relation to SRI management in order to evaluate the reality of the practices described by management companies, to identify good and bad practices, and to provide input for the 2019 SRI Report. Finally, a key supervision focus will be monitoring the marketing of green and sustainable investment themes, via the AMF's surveillance tools (particularly advertising).

Sophia Bennani
Inspection
Directorate

Our inspections of SRI management check the consistency between the framework put in place by management companies and the information provided to investors. Several areas are assessed: the organisation, the investment process, the data, the procedures and the engagement policies. This approach enables us to comprehend the diversity of the methods adopted.

❸ Participating in European regulatory work and collaborating with other regulators

The initiatives stemming from the European Commission's Action Plan may introduce amendments to a large number of texts governing entities regulated by the AMF (MiFID, UCITS, AIFMD, Benchmarks, Prospectus, PRIIPs, etc.). Whatever the outcome of the discussions that are under way, the work will continue in 2019 in several areas that will require the involvement of the AMF (work within ESMA), or, at the very least, will require monitoring (for example the work carried out within the European Corporate Lab set up by EFRAG or within the Technical Expert Group (TEG) set up by the European Commission).

Cooperation with other regulators is also an important avenue for sharing French experience, jointly reflecting on the role of the regulator, on the appropriate regulatory framework and on the approaches that may be

[5] AMF, *Rapport sur l'investissement socialement responsable (Report on Socially Responsible Investment)*, December 2017.

developed in relation to innovation or in terms of supervision. Besides the exchanges with our counterparts in Europe, the AMF will participate in the informal regulators' network recently established at international level within IOSCO.

Finally, our **work with the Banque de France and the ACPR** is indispensable, both in respect of investor protection, as part of the AMF-ACPR Joint Unit, and also in respect of the actions taken in the area of financial sector reporting and the forthcoming macro-prudential work (climate stress tests, for example).

❹ Educating savers

Sustainable finance poses a **specific challenge for retail investors**, both due to the development of a new range of products and the emergence of strong convictions, on the part of at least a portion, of the savers. Several questions arise from their point of view in order to understand the information received, select their investments whilst being certain, if that is what they want, of the impact and of the actual financing of a "greening" of the economy or of sustainable activities and practices, and to grasp the possible impacts in terms of performance or risks. Brochures on solidarity finance and SRI funds have already been prepared in 2016/2017; a video for the general public will also be broadcast on television at the end of the year in partnership with the INC (National Institute for Consumer Affairs). New **specific content** will be devised by the AMF, in collaboration, where appropriate, with its partners, such as the IEFP (the Institute for the Financial Education of the Public), in order to facilitate the understanding of certain terms (impact investment, best in class, low-carbon funds, thematic funds, etc.).

❺ Developing internal expertise and governance

Integrating the sustainable finance objectives into the AMF's tasks and activities requires two commitments: firstly, building or acquiring the necessary skills and consolidating the cross-disciplinary approach implemented at the AMF; secondly, involving the AMF's Executive Committee and Board in this challenge for the future.

Julie Ansidei
Regulatory Policy and International Affairs Directorate

> A more sustainable financial model requires mobilising different levers and working together. The creation of a Strategy and Sustainable Finance Unit at the AMF, responsible for coordinating the various initiatives and for implementing the roadmap, is a sign of the regulator's commitment to sustainable finance.

Several initiatives have already been taken over the course of the year to raise the awareness of all the teams, to ensure the sharing of knowledge and to develop exchanges with external experts. These efforts will continue and their organisation will be formalised with the creation of a Strategy and Sustainable Finance Unit, the launch of a Sustainable Finance Task Force responsible for implementing the AMF's 2019 roadmap and for leading an internal community representing all the directorates. Job descriptions will progressively take these needs into consideration, and CSR or SRI profiles may be favoured during recruitment so as to integrate experience "on the ground" of ESG issues into the teams. In the AMF's consultative bodies (Consultative Commissions, Scientific Advisory Board), it will be necessary, in particular, to consider ways of increasing the participation of representatives with relevant experience in the area of sustainable finance and of ensuring regular exchanges. Lastly, the AMF's commitment is demonstrated by the involvement of its Board and its Executive Committee in these subjects. It will be accompanied by the formalisation of the AMF's CSR policy.