



HLEG final report: What does it mean for Luxembourg?



**LUXEMBOURG
GREEN EXCHANGE**
by Luxembourg Stock Exchange

Foreword by Julie Becker

The "raison d'être" of the European Commission's High-Level Expert Group (HLEG) on Sustainable Finance has been the development of a comprehensive EU roadmap on sustainable finance. The task has not been an easy one. The financial system, with its policy and regulatory framework, is so complex that there is no silver bullet to turn it towards sustainability overnight. However, the merits of the HLEG's report are that it identifies areas that urgently need action and gives concrete recommendations for the way forward.

There are a couple of recommendations that are particularly relevant for us here in Luxembourg.

The first, and most fundamental, is the building of a common sustainability taxonomy. Without this backbone the success of the remaining HLEG proposals will probably be limited.

The second recommendation, which touches the heart of Luxembourg's green finance initiatives, is the proposed EU Green Bond Standard (EU GBS). As you will read further on, Luxembourg has pioneered this trend. The EIB's listing of the first Climate Awareness Bond in 2007 and the launch of the Luxembourg Green Exchange (LGX) in 2016 are excellent examples. With its launch, LGX made industry best practices for green bonds a mandatory requirement. It is safe to say that if an EU GBS were implemented tomorrow, all green bonds displayed on LGX would comply.

The third area of interest for Luxembourg's financial sector is that of fund labels. LuxFLAG's suite of labels addressing investment funds and bonds perfectly positions it as the leader in the sustainable finance labelling landscape.

There are also other recommendations likely to drive cross-cutting change. Clarifying the fiduciary duty is one of them. It will help raise interest at board level of companies and thus lead to increased consideration of ESG issues in organisations. Extending the traditional focus on investment risk and return, so that it also encompasses ESG values and their appropriate embedding in investing mandates, will be another driver of change.

In Luxembourg, we are known to be fast movers and that has kept us ahead of the game in the financial sector over the past 30 years. The recommendations of the HLEG final report represent interesting opportunities for plenty of financial sector professionals.

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Rethinking the purpose of finance in Europe...

There is an inextricable link between mitigating climate change and the development of sustainable finance. Without sufficient funding, meeting the targets set out in the Paris Agreement and the UN 2030 Agenda for Sustainable Development will prove impossible. One obstacle that sustainable finance faces on its way to growth is the lack of a fully developed market for sustainable and green investments that would encompass common standards, incentives and safeguards. It would also entail the transformation of the current financial sector, to support a more sustainable and inclusive economic system.

The European Union is set to lead this change and strengthen its position as a frontrunner in the area of green and sustainable finance. It has already started looking into regulatory initiatives that could mobilise private capital and, thus, address the funding shortfall. Appointed in December 2016, the HLEG¹ on Sustainable Finance has recently published comprehensive recommendations to help the European Commission accelerate the shift to sustainable finance.

The HLEG brought together members and observers from banking, insurance, asset management, stock exchanges, financial industry associations, international institutions, civil society and others to focus on concrete measures to align the European financial system with global objectives for sustainability. The HLEG's final report, published on 31 January, puts forward eight key recommendations, mostly related to the implementation of a common taxonomy, clear standards, investor duties, disclosure rules, and sustainability labels. It also analyses existing challenges for financial institutions and gives sectoral recommendations to help tackle them.

The European Commission has committed to putting forward a broad Action Plan on sustainable finance, building on the recommendations of this report, in March of this year. The Action Plan is likely to lead to some real changes in financial policy and improve the EU's sustainability performance. What will that mean for one of EU's leading financial centres and the green bond capital of the world?

...and in Luxembourg

The Grand Duchy of Luxembourg is fully committed to embracing transformation and the transition to a low-carbon economy. The country is a founder signatory of the Casablanca Statement committing to join forces with nine other leading financial centres to promote strategic action in green and sustainable finance.

Since 2015, the government and the financial services industry have been working together in a dedicated Climate Finance Task Force, implementing an integrated strategy. Its aim is to make a meaningful contribution to the international fight against climate change and to reinforce Luxembourg's role as an international centre for sustainable finance.

The national strategy² is built around four objectives:

- Consolidate and leverage Luxembourg's existing expertise in sustainable finance to drive and develop climate finance capabilities;
- Enter into strategic partnerships with climate finance leaders, such as the European Investment Bank (EIB) and the International Finance Corporation (IFC);
- Ensure quality control in the specific area of climate finance through standards and dedicated labels; and
- Encourage innovation in climate finance.

Early actions in the area of sustainable finance by public and private actors have allowed Luxembourg to develop into an international platform for sustainable finance. The country is home to 1 in 3 European responsible investment funds, 2 in 3 European impact funds and half of the world's listed green bonds are displayed on the Luxembourg Green Exchange (LGX).

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- The first step to growing sustainable finance initiatives will be the establishment of the EU Sustainability Taxonomy.
- Standards and labels will be built upon this taxonomy, introducing trust, credibility and comparability across different investment products.
- Information about the sustainability impact of different assets, activities or projects will become a must-have. Simple, clear, comprehensive and standardised disclosure/reporting is a critical element to ensure investor trust.
- Sustainability behaviours will be reinforced through legislative clarity on the responsibilities of governing bodies. This will extend to knowing the sustainability preferences of beneficiaries and clients, in addition to the risk/return profile, and being required to act in the best interests of these investors, bearing their sustainability preferences in mind.
- Educating market participants across the board will be a major challenge faced by every financial sector professional, both in terms of education needs and when it comes to building awareness among clients.
- Looking forward, the "Think sustainability first" principle will be key in the update and development of new legislation and regulations. Considering sustainable elements in the development of all legislation will be critical to ensure coherence and consistency across sectors and products.

By 2020, most of these suggested points should be implemented, moving us closer to a truly sustainable financial system.

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The HLEG final report pulls together several recommendations for the European Commission. They cover priority measures that the expert group identifies as essential building blocks for wider actions, some cross cutting recommendations, as well as sectoral recommendations.

We have selected areas that may be particularly relevant to Luxembourg and its specificities as a leading international sustainable financial centre.

The backbone of the sustainable financial system – a common sustainability taxonomy

One of the key challenges faced by financial sector professionals today is the lack of clear and harmonised language and definitions of what is "green", "sustainable", "social" and many other terms used to describe sustainable assets, projects and activities. Without a sustainability taxonomy, scaling up investments in sustainable assets and projects will remain challenging. The HLEG has suggested a roadmap to develop a fully-fledged sustainability taxonomy by 2020, which includes the following key steps:

- Establishing a dedicated sustainability taxonomy working committee which will develop the taxonomy and a structure for its long-term governance;
- The working committee will, among others:
 - » Develop definitions, screening criteria, thresholds and metrics across the whole sustainability taxonomy framework;
 - » Design procedures to address case-by-case assessments;
 - » Explore the need to assess potential trade-offs between different sustainability themes;
 - » Formally recommend the endorsement by the European Commission of the different taxonomy components.

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Where does Luxembourg fit in?

Agreeing on an EU-wide taxonomy is essential. There are differing definitions of certain sustainability concepts across member states. Examples might include topics such as nuclear energy, hydro-electricity projects, etc. Without a fully-fledged sustainability taxonomy in sight, the remainder of the recommendations will lose much of their impact.

A step-by-step approach to building a robust taxonomy and then to building regulation around it are non-negotiable must-haves.

Both the Luxembourg government and the Luxembourg financial sector have extensive experience in setting up a taxonomy in the environmental and social areas. This know-how has been built over the past 15 years supporting domestic, but also international financing of social projects through microfinance. A whole ecosystem of expertise exists, focused on providing financing to the underserved in developing countries through microloans and other financial products. Two thirds of the world's microfinance funds are domiciled and managed in Luxembourg.

This is also the case in the area of climate finance – the first part of the proposed EU Sustainability Taxonomy, dedicated to climate change mitigation, is largely based on the taxonomy developed by the European Investment Bank (in collaboration with other multi-lateral development banks). The government has also recently issued a draft law on green covered bonds, the very first of its kind in the world, where it clearly defines what is considered "renewable energy".

Sharing this experience, both from the social and environmental perspectives, as well as contributing to the development of a European sustainability taxonomy and ensuring that it lives up to the strict criteria already considered in Luxembourg, are great opportunities to position our financial sector and its expertise.

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Addressing the retail fund market through recommendations around enhanced disclosure and labels

Ensuring that investor preferences are taken into account is a topic covered throughout the report. It is equally important across both institutional and retail investor spheres. Enhancing awareness and education, providing strong, simple and understandable disclosures, setting minimum standards for sustainable investment products are all fundamental principles to ensure retail investor protection, as well as to build better awareness and trust. With this in mind, the HLEG has laid down several recommendations.

Fund disclosure requirements

The HLEG recommends that the European Commission requests all funds destined for the retail market to disclose:

- Clear and understandable information on their sustainability impact; and
- Information on the exercise of their voting rights.

These disclosure requirements would be applicable to funds with total assets under management exceeding EUR 500m in an initial phase. The overarching objective is to make available a small range of simple, understandable metrics, to allow retail investors understand the impact of their savings. The report also recommends that these metrics include exposure and strategies related to climate risks and opportunities.

Fund servicers can take this opportunity and extend the scope of their reporting offering. Fund administrators will need to develop tools to capture and report the required information in an efficient, cost-effective manner, building on existing reporting expertise, but also through the development of new partnerships with specialist consultants.

Confusing terminology

The use of numerous sustainable denominations such as SRI, ESG, RI, green and the likes to describe investment products with very different strategies is confusing for market participants. The HLEG recommends that the European Commission sets minimum Socially Responsible Investment (SRI) standards, aligned with the EU sustainability taxonomy, which must be respected by all funds wishing to use a sustainable denomination. That means that every fund using a sustainable finance linked denomination must comply with the minimum standard set by the EU.

Fund labels

The HLEG also recommends establishing a voluntary European green label, possibly based on the EU eco-label model. The proposed EU green label, which is expected, at the latest, in early 2019, should first be rolled out to investment funds and then to other retail products.

The HLEG has already established a subcommittee under the supervision of the European Commission, with the objective of developing the model for an EU Green Label dedicated to sustainable finance products. The members of this subcommittee are representatives of European labelling agencies, including LuxFlag.

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A green bond standard will pave the way to standardising other products

EU Green Bond Standard

The green bond market has benefitted from the development of market-led standards. They have simplified and standardised the selection process and criteria for green projects, opening the dialogue between issuers and investors on criteria and impact.

Based on this success, the HLEG has recommended the creation of an EU Green Bond Standard (EU GBS), which will make certain currently voluntary market best practices mandatory for EU green bonds. The proposed EU GBS mandates requirements such as external reviews and post issuance reporting for those issuers who wish to call their green bond an "EU Green Bond".

Standards for other EU Sustainable Finance products

Green bonds are, however, only the first step. The sustainable finance market will further diversify with other products such as green, social, sustainable bonds and loans, as well as green asset backed securities and securitisation products, which are also needed if we want to scale up investments dedicated to sustainability. The EU GBS is definitely a model for the development of more structured standards for other products.

The HLEG recommends taking a path that we, at the Luxembourg Stock Exchange, have already taken two years ago with the launch of LGX. The LGX eligibility criteria set for sustainability and social bonds are arguably the highest in the world now.

A label for green bonds and other sustainable finance products

In addition to the EU GBS, the HLEG has also recommended considering the development of a green bond label.

Labels are extremely useful tools when it comes to the retail market. As the green bond market scales up, a green bond label could be an excellent tool to allow retail and less specialised investors make their investment decisions.

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The HLEG has not only made recommendations on specific topics, but also cross-cutting recommendations that apply across the financial sector and even more widely.

Investing in line with the preferences of the ultimate beneficiaries

An underlying principle in every investment mandate is to invest in accordance with the investors' preferences. Financial institutions handling client monies, whether they are credit institutions, insurance companies, pension funds or asset managers, have effective ways of capturing their clients' risk appetite and return profiles. In addition, mandatory disclosure of risk and return information is required in documents such as the UCITS key investor information document (KIID). This profiling, however, does not yet include an extensive consideration of investors' investment horizons and sustainability preferences.

One of the key recommendations of the HLEG is to clarify investor duties in the relevant legislation. Briefly, this means that asset owners, investment intermediaries, pension funds and asset managers should:

- Understand the broad range of interests and preferences of their clients, including ESG factors;
- Ensure that investments are consistent with their clients' investment time horizons;
- Provide clear information about potential benefits and risks, including effects on prospective returns.

It is considered insufficient to look at the financially significant investors only; HLEG recommends that, whether financially significant or not, the preferences of clients and beneficiaries are to be proactively sought and incorporated into investors' decision-making and the demands that the clients and beneficiaries make on asset managers and other market participants with which they interact.

MiFID rules already require advisors to offer products that are "suitable" to investors' needs. It is, however, difficult to see how the requirement can be met by advisors if they are not required to ask about sustainability preferences. Making such considerations mandatory, either through updates to MiFID or other legislation would certainly contribute to the change.

This concept of extended know-your-customer (KYC), also from a sustainability angle, goes hand in hand with the recommendation to embed a commitment to sustainability within the mandate of the governing bodies of companies, including financial institutions, as detailed further on.

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What does this mean for Luxembourg?

Luxembourg is a leading cross-border distribution hub for funds and a leader in solutions for mandatory investor reporting. The above recommendations have far reaching implications for the education of investors, collecting their preferences and then ensuring that those responsible for managing client monies have access to the information and appropriately consider it.

Developing expertise in the collection and management of this kind of data is a clear opportunity. If that is combined with the current fintech solutions in the area of KYC, powered by blockchain platforms, Luxembourg is one step ahead of its competitors, with all the processes and systems already in place.

Organisations other than investment funds will face the challenge of implementing the necessary processes and procedures to collect such information.

We are clearly moving towards a model where investors will have to become more knowledgeable about their sustainability preferences, even if many are not today. And as their knowledge scales up, so will the demand for sustainable finance products. More and more insurance companies and banks are exploring their sustainability-linked products offering. A review of legislation, such as Solvency II, or the discussions around a possible green supporting factor could positively contribute. Those who are prepared to seize this opportunity and embrace the development of new products can only expect to win.

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Education: from the laymen, to financial professionals and chief executives

The recommendations impact every investor, small and large, financially educated or not, and all their financial intermediaries. This represents an enormous challenge: to educate all financial market participants. New responsibilities with regard to sustainability at each stage in the investment chain may be introduced.

Awareness programmes will be required across the board. This could begin with stock exchanges, for example, which already have an important role in bringing together investors and issuers and possess great financial expertise.

Every financial institution will need to implement internal programmes as well as client educational programmes. Existing financial literacy programmes will need updating. Now is the time to put Luxembourg on the sustainable finance education map with the development of extensive education programmes.

Fintech innovation

One topic that is only briefly touched on in the report is the role fintech can play in the development of sustainable finance. Like in every other area, we can only hope to advance if we use technology as a tool for progress. More data will need to be collected, disseminated and then sent back to investors in a simple and manageable format. Along with this, as expertise increases in areas such as climate risk analysis, the complexity is likely to grow as well, increasing the demand for more in-depth analysis and simple reporting.

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Building a truly sustainable financial centre

Many of the world's leading financial centres are adapting their strategy to a more sustainable finance model. The International Network of Financial Centres for Sustainability now boasts over 20 active members, after less than six months of existence. In an immature market, there are opportunities for all to make their mark – there will clearly be competition, however, there will also be many opportunities to cooperate, share knowledge and build on existing experience to advance the worldwide sustainable finance agenda. Building a network could also help opening markets that historically have been impossible or very difficult to access (for both inbound and outbound investment), such as China.

Stock exchanges play a key role as a central focal point for each financial centre. There are already several initiatives among some European stock exchanges. The HLEG refers to the voluntary toolkit for stock exchanges to grow green finance, prepared by the Green Finance Advisory group of the UN Sustainable Stock Exchanges Initiative, chaired by the Luxembourg Stock Exchange. The toolkit pulls together some recommendations and best practices across the world's exchanges.

Incentives to boost green investment

Some serious reflection needs to go into how to incentivise scaling-up allocation of investments to sustainable assets, projects and activities. There has been much discussion about incentives to support investment in green activities versus to penalise investment in so-called "brown" activities. The clear interest in considering a green supporting factor by the European Commission, as mentioned by Vice-President Valdis Dombrovskis in December 2017, has brought up much debate, particularly around the impact on financial stability. Member states might also consider implementing tax incentives to contribute to the scaling-up of investment in sustainable finance tools.

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There are many recommendations in the HLEG report and many discussions around them. In the near future, we hope to see European policies, inspired by these discussions, taking shape and positively impacting the growth of sustainable finance. We may see full adoption of the roadmap set in the report or adaptations to suit national preferences.

What is critical, however, is the need for clarity in definitions, which will come when the EU sustainability taxonomy is finalised and endorsed.

It's time to act now!

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