The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

BETTER FINANCE's feedback on the European Commission's proposal for a regulation amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks

***BETTER FINANCE**, the European Federation of Investors and Financial Services Users, is the dedicated representative of financial services users at European level. It counts about fifty national and international members and sub-member organizations in turn comprising about 4.5 million individual members. Our organization acts as an independent financial expertise centre to the direct benefit of the European financial services users (shareholders, other investors, savers, pension fund participants, life insurance policy holders, borrowers, etc.) and other stakeholders of the European financial services who are independent from the financial industry. As such its activities are supported by the European Union since 2012.*

***BETTER FINANCE** is the most involved European end user and civil society organisation in the EU Authorities' financial advisory groups, with experts participating in the Securities & Markets, the Banking, the Occupational Pensions and Insurance and Reinsurance Stakeholder Groups of the European Supervisory Authorities; as well as in the European Commission's Financial Services User Group (FSUG), and in the European Financial Reporting advisory Group (EFRAG). Its national members also participate in national financial regulators and supervisors bodies when possible.*

For further details please see our website: http://betterfinance.eu/

BETTER FINANCE welcomes this opportunity to comment on the Commission proposal on low carbon benchmarks and positive carbon impact benchmarks released as part of the Sustainable Finance Action Plan of the European Commission.

EU citizens as savers and individual investors are the main provider of long term funding to the EU economy and are mostly by nature long term oriented, as their needs are often long-term ones: pension, home purchase, children education, etc. Therefore, they are concerned with the impact of the investment of their savings on sustainability.

BETTER FINANCE is a strong advocate of sustainability, but it wants to make clear that this will be essentially achieved:

- First, by Public Authorities identifying precisely the beneficiaries of what the economists call the "negative externalities" of human activities and businesses on the ecosystem, and then adequately taxing these negative externalities for the beneficiaries to pay the right price of hurting the environment. That is by far most powerful and effective. The carbon tax is a good step in this direction.
- Second, by improving corporate governance and ensuring the long-term engagement of shareholders and investors by addressing the "agency ownership" issues and removing the barriers to share voting by the ultimate and economic owner.
- And only third, by aligning the interests of investment intermediaries (asset managers, pension funds, financial and insurance distributors and advisors) to the time horizon and interests of the end investors (mostly the citizens as long term and pension savers).

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One recent example can illustrate our position. This year, BETTER FINANCE and others campaigned for a major European based oil company to align its business with the goal of the Paris climate agreement to limit global temperature rises to well below 2 degrees above pre-industrial levels. Such a resolution, if successful, would have been much more effective for sustainability purposes than to sell out the stock of that company. However, this resolution was backed by only 5.5% of votes. Individual and other small shareholders face multiple obstacles to exercise their voting rights. These hurdles are not fully addressed by the new Shareholders Rights Directive of 2017: "agency" ownership, nominee accounts and global custodians voting in place of the economic share owner is one of the main problems identified[1].

1. **Clarify the definitions and uses of "financial market participants" and of "investors"**

BETTER FINANCE wishes to analyse the EC proposal from the point of view of EU citizens as individual investors and savers, most of whom are clients of financial intermediaries such as fund and asset managers, pension funds, investment and insurance advisors. All these professional intermediaries are not the end investors, they just deal with other people's money. End investors - usually not investment intermediaries – bear the costs, risks and rewards of the investments. Louis Brandeis (one of the founders of the US SEC)[2], Prof. John Kay[3], as well as BETTER FINANCE call the investment intermediaries "OPM" ("Other People's Money").

The proposed Regulation should make clear that the carbon benchmarks should be used by professional investment intermediaries, but not in general by individual end investors (see the reasons below).

2. **Keep and properly disclose mainstream benchmarks as key performance assessment tool for savers and individual investors**

> "There may be also value in assessing whether a fund has been able to achieve the objectives referred to in the fund documentation."
>
> *(ESMA recommendation, February 2016 Communication on closet indexing)*

In layman's terms, this implies that investment products must have measurable objectives, and the managers must disclose in an intelligible way how they have tracked these quantified objectives over time: i.e. their benchmark's performance must be disclosed alongside the one of their products (EU Regulation (EU) No 583/2010 of 1 July 2010, articles 7 and 18).

[1] On this topic, please see BETTER FINANCE's positions paper on the implementing act of SRD II http://betterfinance.eu/fileadmin/user_upload/documents/Position_Papers/Securities_Market/en/BETTER_FINANCE_s_feedback-_IR_on_minimum_requirements_in_the_transmission_of_information_for_the_exercise_of_shareholders_rights.pdf

[2] Louis Brandeis - *Other People's Money and How the Bankers Use It* (1914)

[3] John Kay - *Other People's Money: The Real Business of Finance* (2015)
In 2012 he provided a substantial report to the British government on reform of the equity market, which suggested that "*the stockmarket exists to provide companies with equity capital and to give savers a stake in economic growth. Over time that simple truth has been forgotten*"

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Benchmarks are used to assess the performance of a security, mutual fund, other packaged investment products and investment managers, and are therefore extremely useful for individual investors as a point of reference for evaluating a fund's performance.

Politicians, the media, rules makers and financial intermediaries already often do not properly understand and use standard indices (capital markets performance benchmarks). They too often:

- Confuse price indices and return indices (for example, politicians and media routinely comparing the French CAC 40 price performance to the German DAX 30 return one, although the first one does not include reinvested dividends, which generates a huge difference over time).
- Confuse narrow big cap indices with "market" indices - broad indices including mid and small caps (for example routinely using the Stoxx Europe 50 as a proxy for the "European equity market": more than 10 000 listed companies instead of 50!)
- Do not enforce the mandatory disclosure of benchmark performance alongside the UCITS funds' performance in the Key Information Document (KIID). BETTER FINANCE research found indeed that the vast majority of UCITS equity funds is benchmarked (94%), but that a majority of benchmarked UCITS equity funds from the main fund domiciles (Luxembourg, Ireland) do not disclose their benchmark's past performance alongside the one of the fund in their Key Investor Information Document (KIID);
- Thus disallowing investors from following ESMA's recommendation to assess whether a fund has been able to achieve its own objectives.

BETTER FINANCE believes therefore that the EU should first strengthen the rules and their enforcement on the standard indices to be properly understood and used by financial intermediaries, before adding environmental specific indices, at least for disclosure to end-investors.

There are today different approaches to benchmark methodology but retail investors usually do not know the methodology used by benchmark providers to include ESG objectives. These different approaches do not allow for effective comparison and this lack of transparency affects the reliability of these new benchmarks.

In its Action Plan[4], the European Commission aimed at increasing the transparency by setting a transparent and sounder sustainable indices' methodology (to allow an objective comparison and to improve the performance assessment of low-carbon funds).

We welcome this initiative but we believe that what individual investors need is mainstream capital markets' benchmarks ("standard indices" as the EC calls them) (1) allowing them to easily assess the performance of different funds against the same benchmark. Although the Action plan was quite ambitious[5], the proposed amendments to the Benchmark regulation are more than disappointing (2).

[4] European Commission Sustainable Finance Action Plan https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

[5] BETTER FINANCE's press release - BETTER FINANCE welcomes the sustainable finance action plan but warns the commission against its plans regarding taxonomy, benchmarking and an eco-label http://betterfinance.eu/fileadmin/user_upload/documents/Press_Releases/en/Other_investors/PR_-_Sustainable_Finance_-_210318.pdf

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BETTER FINANCE already pointed to the need to measure and clearly inform EU savers about the impact of applying ESG criteria on the actual long-term real performance by allowing for the comparison between the actual performance and the corresponding **mainstream capital markets' benchmarks**.

ESG products must benchmark themselves against objective mainstream benchmarks to allow to check (1) if their ESG approach made any difference over the long term (it would be impossible if the funds are using specific "sustainability" benchmarks instead or no benchmark at all) and (2) if they created any long-term value for EU savers. The Key Information Document must refer to - and disclose a mainstream benchmark in order to be intelligible, which is a legal requirement from the MiFID Directive: information must be intelligible to the majority of people to whom it is targeted[6]. Mainstream benchmarks are already poorly explained to end investors. It will be worse with more specific and technical indices.

The PRIIPs Regulations have most unfortunately eliminated the disclosure of benchmark past performance alongside the performance of the investment product, preventing EU citizens as end investors from assessing the performance of the investment managers.

The PRIIPs Regulations have also **eliminated the long-term focus** of performance disclosure of UCITS IV (10-year minimum requirement) to a much shorter time horizon of five years (last five-year performance volatility is to be used for the PRIIPs KIDs, even for very long-term investment products such as life cycle retirement funds). The long-term disclosure of mainstream benchmark performance alongside the investment product's one is the only way to reconcile sustainability and long-term value creation. Long term value creation is crucial for sustainable investment products aimed at individual investors as recognised by the HLEG[7].

Below is a good example of how to combine investments in sustainable assets / securities and long-term value creation; it is a sustainable UCITS equity fund that was granted an official "SRI Label" by the French national Authorities (extract from the fund's KIID's investment objectives and policy section):

« En souscrivant à ... ACTIONS EUROPE ISR, vous investissez dans des actions des entreprises de l'Union Européenne ***en tenant compte de critères liés au développement durable****.*
L'objectif est de réaliser une performance supérieure ou égale à celle de son indice de référence, le MSCI Europe (dividendes réinvestis), représentatif des principales capitalisations boursières des pays de l'Union Européenne, après prise en compte des frais courants.
Pour y parvenir, l'équipe de gestion intègre des critères extra-financiers (sociaux, environnementaux et de gouvernance d'entreprise), en complément des critères financiers traditionnels, dans l'analyse et la sélection des valeurs. »

[6] Article 24(3) of MiFID II 2014/65/EU and Article 44 Commission Delegated Regulation (EU) 2017/565

[7] *"incorporate long-term and sustainable value creation and improve investor governance should be a central objective at the European level"* HLEG Interim report, page 60 https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf

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Then the long term past performance section compares the last 10-year performances of the fund to a quality mainstream index: broad, total return as the fund capitalizes dividends received, and intelligible by the average fund investor provided the "retail" intermediary is himself able to explain it to his clients.

Even with minimum standards regarding the methodology followed by these benchmarks, multiplying these low carbon and positive-carbon impact benchmark will not help retail investors to easily compare the funds' performance with each other.

The use of carbon benchmarks in lieu of (instead of in addition to) standard objectives capital market indices in key disclosures to end investors will not reduce but increase the information asymmetry between professional investment intermediaries and the people as end investors. Worse, it may well be used as an additional smoke screen helping investment intermediaries ("Other People's Money") to avoid being accountable for the long-term performance of their services to their clients. In any case, it will not be compliant with MiFID II which requires information to be clear and intelligible.

3. **<u>Any benchmark methodology must follow the EU taxonomy</u>**

The proposed regulation provides that the Commission will be empowered to enact delegated acts which will specify the minimum standards for harmonisation but these delegated acts will not require administrators of low carbon and positive carbon impact benchmark to use the EU taxonomy when designing parameters of the methodology for selecting underlying assets.

The Commission justifies the choice to unbundle the methodology from the EU taxonomy by the fact that it will give more flexibility to index administrators.

We strongly disagree with this choice: the ESG approach is not new and one of the main purposes of the Action Plan was to establish an EU taxonomy that would be followed by all the market players in order to clarify for retail investors which investment can be considered as sustainable.

As representative of end investors and users of financial services, we support the Sustainable Finance Action plan but we warned[8] the Commission that before including ESG criteria in products sold and requesting asset managers to advise retail investors on ESG consideration we need a clear and common EU taxonomy. With this proposed regulation index administrators won't even have to follow the EU taxonomy when selecting the underlying assets. It would certainly not be a good start to establish an EU taxonomy by exempting the carbon investment indices from using it!

4. **<u>Properly disclose to EU savers and individual investors the limitations of carbon benchmarks</u>**

There should be a prominent warning to end investors that carbon benchmarks cover only a very specific part of environmental issues (not mentioning "ESG" as a whole), even regarding climate change only,

[8] BETTER FINANCE's press release - BETTER FINANCE welcomes the sustainable finance action plan but warns the commission against its plans regarding taxonomy, benchmarking and an eco-label http://betterfinance.eu/fileadmin/user_upload/documents/Press_Releases/en/Other_investors/PR_-_Sustainable_Finance_-_210318.pdf

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as, for example, there are other gases than carbon oxides – C0x - that impact climate and global warming (e.g. nitrogen oxides – NOx – in particular from cars).

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