Rethinking the European financial system

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Summary

The consequences of systemic changes, such as climate change and resource depletion, guide us to embark on a more sustainable path – for the sake of our planet, economy and society at large.

The European capital markets have an essential role to play in this transition. The purpose of this brochure is three-fold:

- To explore the most recent sustainability trends in the financial system. Particularly, in light of changing social expectations, increasing environmental pressures and commitment to the Paris Agreement on climate change (hereafter COP21) and UN Sustainable Development Goals (hereafter SDGs).

- To identify the actions taken and measures proposed by the European Union in the last two years.

- To analyze the challenges at the capital market, organizational and financial institution level.

The report concludes with calls to action to address the trends and turn challenges into opportunities. This is underpinned by the proposed options to facilitate environmental, social and governance (ESG) integration and lead the transition to a more sustainable European financial system.
Impact of sustainability trends on the financial system

There has been a shift in the current value paradigm toward more sustainable business practices governed by changes in social expectations and increasing environmental pressures. The incentives for the financial system, in its current modus operandi, to contribute to ESG-driven capital allocation are despite this observation still in an early stage of development. Therefore, the basics underlying the European financial system require rethinking.

The International Integrated Reporting Council (IIRC) advocates the adoption of a “multi-capitalistic” approach by firms, investors and other key players in the capital markets. Rather than focus solely on shareholder value and financial capital (i.e., mono-capitalism), multi-capitalism aligns the creation of social and environmental value with economic value. Furthermore, it represents a shift from shared value to system value, as it recognizes that ESG aspects are not only intertwined, but that business is in fact fully dependent on a flourishing society. This, in turn, is only possible if organizations operate within the planetary boundaries of the earth.

The global commitment to the transformational COP21 and the UN 2030 Agenda marks a stepping stone toward a more sustainable future. Nonetheless, according to the High-Level Expert Group on Sustainable Finance (HLEG), the achievement of the sustainability targets as set in Paris is rather costly. In Europe alone, an investment gap of approximately €180 billion a year is expected for the coming two decades and beyond – greatly exceeding the capacities of the public sector. For this reason, the financial sector could play an essential role in leading ESG integration. By focusing on a longer term and sustainable investment horizon, the sector can facilitate better decision-making and long-term value creation.
Meta-changes
The need for systemic change in the financial sector to cater to the circumstances of the 21st century is now greater than ever. We are observing changing customer expectations, partially driven by millennials that wish to be part of organizations – both as an investor and an employee – that are aligned with their personal beliefs and values. The recognition of the significance of an ESG dimension has also been embraced by regulators and policy-makers in various forms, which are elaborated on in the subsequent chapter. The commitment to COP21 and the SDGs coupled with the realization that private funds are essential in the accomplishment of these goals sparked the notion to rethink the financial system. Additionally, three major triggers are attributable to these thinking paradigms. The first one being the uncertainty and distrust toward the financial system because of the global financial crisis, which first led to the notion to rethink the underlying architecture; secondly, the rising importance of developing countries and recognizing the potential of the financial system to be a catalyst for their development; and lastly, technological disruptions and digitalization providing novel solutions to achieve the goals.

These meta-changes are perceived to be the major drivers behind the notion to rethink the financial system.

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1 For more information, please visit: http://integratedreporting.org/news/from-monocapitalism-to-multicapitalism-21st-century-system-value-creation/

In December 2016, the European Commission established the HLEG, which comprised of representatives from the financial sector, academia and civil society. Their action plan on Sustainable Finance was adopted by the European Commission in 2018 and a package of proposed measures ensued. In 2019, the political decision making process has already moved forward significantly.

The underlying idea of the EU proposals is to render ESG factors more data-driven and comparable across the entire value chain. In more concrete terms, the proposals for the requirements to financial institutions are four-fold. The first two primarily impact asset owners, such as banks, insurance companies and pension funds.

1. **Identify direct climate change risk for the financial institution.** The insurer should take climate change risks into account in the risk modelling approach by the utilization of catastrophe models. For example, an event where an insurer for farmers may need to pay out more in case of severe weather resulting from climate change.

2. **Identify the indirect ESG risk.** Changes are especially relevant in terms of the environment, in the form of stranded assets. For instance, if a firm is forced out of business due to the Paris agreement, investments in that firm will lose value. This is a financial risk that must be dealt with in the risk management processes.
The other two requirements primarily impact those financial institutions investing on behalf of others and aims also to protect investors.

3. **Disclose how ESG factors are considered in the investment selection process.** Performing an initial screening of an investment opportunity allows for an early assessment on the extent of the alignment with ESG objectives.

4. **Take into consideration ESG preferences by asset owners.** Banks, investment managers and insurance companies should consider integration ESG preferences into their suitability tests when providing financial advice or portfolio management to private individuals or entities.
Challenges for the actors in the financial system

The capital markets
The changes and related developments require profound reforms and cooperation among all the actors involved in the financial system. The underlying question is: how can the system be changed to move the economy to the desired economic model with characteristics such as low-carbon, resource efficiency, and more circularity? EY research among institutional investors globally reveals that there is already notable consensus that ESG information is critical to investor decision-making and that change in this respect is on its way. In this study, investors report that the main ESG factors in investment decision-making are risks related to governance, supply chain, human rights and climate change, and that the impact of these factors is evolving rapidly as expressed in the table opposite.3

If this outcome is combined with the trends impacting the financial system and the actions taken by the European Commission, it is imperative that the capital markets adjust themselves to respond to these changes toward an economic model of sustainability. Although this adjustment is still work in progress, the future capital markets could look as pictured below. Shareholder orientation is hereby replaced by stakeholder orientation and the single financial capital approach is broadened to a multi-capital perspective, integrating financial, natural and social capital.
<table>
<thead>
<tr>
<th>Disclosure</th>
<th>2018</th>
<th>2017</th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk or history of poor governance practices</td>
<td>63%</td>
<td>32%</td>
<td>5%</td>
<td>3%</td>
</tr>
<tr>
<td>Risk in supply chain tied to ESG factors</td>
<td>52%</td>
<td>38%</td>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td>Risk or history of poor human rights practices</td>
<td>49%</td>
<td>44%</td>
<td>7%</td>
<td>32%</td>
</tr>
<tr>
<td>Risk from climate change</td>
<td>48%</td>
<td>44%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Risk from resource scarcity (e.g., water)</td>
<td>22%</td>
<td>68%</td>
<td>10%</td>
<td>12%</td>
</tr>
<tr>
<td>Risk of history of poor environmental performance</td>
<td>17%</td>
<td>78%</td>
<td>5%</td>
<td>15%</td>
</tr>
<tr>
<td>Limited verification of ESG-related data and claims</td>
<td>17%</td>
<td>70%</td>
<td>13%</td>
<td>20%</td>
</tr>
<tr>
<td>Absence of a direct link between ESG initiatives and business strategy</td>
<td>10%</td>
<td>79%</td>
<td>11%</td>
<td>12%</td>
</tr>
</tbody>
</table>

Legend: Rule out immediately, Reconsider, No change

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3 Does your non-financial reporting tell your value creation story? EY, 2018.
If this could be the future profile of the capital market, the following question comes up: how does this impact the actors in the capital market and their aim for long term value creation? This report focuses on the perspective of the financial capital provider (investor) and the companies using, transforming and generating capitals.

Challenges on the financial institution level
Rethinking of the financial system will – in the first instance – affect the activities of banks, pension funds, insurance companies, asset managers and other financial institutions. To be in the desired market position, strategic decisions need to be made to align the provision of financial services with the proposed sustainability agenda. If not, these players will be exposed to significant risks and challenges. First, the failure to respond to stakeholder expectations may result in reputational risk and lack of credibility in the institution. Conversely, the integration of ESG matters in the investment portfolio may serve as a tool to strengthen the license to operate in society. ESG integration is perceived to help mitigate credit risk and assist Know Your Client (KYC) procedures. Second, there is considerable compliance risk reflected in fiduciary duties, disclosure and other ESG-related regulations. The latter refers to, among others, MiFID II, UCITS and AIFMD as stated in the December 2018 advice of The European Securities and Markets Authority (ESMA). This advice is expected to be transposed into binding regulation soon. Last, weak management of ESG criteria will result in passing on untapped opportunities and innovations that sustainable finance presents; green, social and positive-impact bonds, crowdfunding platforms, new marketing channels through vendor partnerships and other ESG-related service offerings. Needless to say, there is a asymmetry between the risk preferences of society as a whole on one hand, and financial institutions and organizations on the other. The organizational perspective is described in greater detail in the following paragraph.

Challenges on an organizational level
The second layer of parties impacted by the previously mentioned sustainability-related changes are nonfinancial organizations. ESG considerations expose firms to a myriad of risks and opportunities that go beyond their core operations. From an environmental perspective, a tool for the management of carbon emissions could be carbon pricing. If regulated correctly – grounded in environmental targets within reasonable pricing boundaries – it could be a major step toward the de-carbonization of the economy. However, carbon pricing can exert significant pressure on an organization’s cash flows and margins. This is reflected in high compliance costs coupled with decreasing public subsidies, increasing impairment charges and changing regulations to accommodate new players and technologies. On the other hand, the physical impacts of climate change present opportunities to firms, such as revisiting the manufacturing process and thereby rendering the business model future-proof. From a social and governance dimension, firms are confronted with matters of diversity, human rights, bribery and corruption, as well as customer protection. Also, technological advances, changing customer expectations and increasing demand for sustainability disclosures are other significant drivers that disrupt conventional ways of doing business. In the next section we will discuss these challenges in further detail, followed by a proposed “call to action” for financial institutions and organizations who are part of the financial system.
Rethinking the European financial system
Call for actions

Considering the increasing environmental pressures and changing societal expectations, it is important to adequately address the challenges associated with ESG integration. The EY Climate Change and Sustainability Services teams provide a range of services to assist you on the journey to more sustainable business practices governed by increased operational efficiency, improved risk management and better communication. ESG integration has become an increasingly valued topic in the discussion of an organization’s long-term (financial) performance. Accordingly, there is an emerging recognition among institutional investors and asset managers that sustainability-related matters can potentially lead to improved financial outcomes. Therefore, the effective reorientation of private capital flows toward more sustainable ventures requires a far-reaching reform in the financial system to provide an infrastructure for sustainable investments. This, in turn, will facilitate capitalizing on the opportunities offered by ESG integration and mitigate the risks associated with it.

The challenges of ESG incorporation concern every step of the process; from defining an adequate sustainability strategy, over the integration of ESG dimensions in the decision-making process, to external (and internal) communication of the sustainability efforts. These challenges are outlined in greater detail below coupled with EY services to help you tackle these challenges.

Sustainability direction and sustainable strategy

The first challenge of the ESG integration process is to define the organization’s sustainability direction. This needs to reflect how the organization is creating societal value in the short-, medium- and long-term based on its business activities and operations. Additionally, material topics, stakeholder analysis and a value creation model have to be determined. To identify and align these aspects is important, as it will demonstrate the relationship between the organization’s financial and nonfinancial performance and guide its path toward deeper ESG integration. It will also express the commitment of business to long-term value creation for stakeholders across society. It is therefore crucial to have insight and agreement on the most important areas, including testable metrics to measure long-term value creation. This is in line with the Embankment Project for Inclusive Capitalism.4

4 Embankment Project for Inclusive Capitalism; Coalition for Inclusive Capitalism 2018
Call for action
Define the sustainability direction and anchor the sustainable strategy into the organization

<table>
<thead>
<tr>
<th>How EY teams can support you?</th>
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<tr>
<td>• Robust sustainability strategy building</td>
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<td>• Design and assess the governance structure toward sustainability</td>
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<td>• KPI development based on the sustainable strategy</td>
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<tr>
<td>• Stakeholder analysis</td>
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<tr>
<td>• Materiality matrix building</td>
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<tr>
<td>• Long term value creation modelling and sustainable financing</td>
</tr>
<tr>
<td>• SDG integration</td>
</tr>
<tr>
<td>• Impact measurement modelling</td>
</tr>
<tr>
<td>• Impact investment feasibility studies including solvency requirements for institutional investors</td>
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</tbody>
</table>

Risk management
Second, the organization should strive to integrate ESG dimensions into the daily decision-making processes, which poses another challenge. ESG integration is not merely of ethical and sustainability value, but can serve as a broad risk management approach. It exposes organizations to a wider set of risks that may not be immediately visible in asset values. In fact, the 2019 Global Risks Report of the World Economic Forum\(^5\) demonstrates that the clear majority of the top 10 most likely risks are of environmental, social or governance-related nature. Similarly, the EY Global Climate Risk Barometer 2018\(^6\) demonstrates that most companies in key economies are still not adequately addressing climate risks, or positioning themselves to take advantage of the opportunities that may arise. Assessing the uptake of the Task Force on Climate-related Financial Disclosures (TCFD) of more than 500 companies, the study reveals that clarity and consistency in disclosures on climate change related risks and opportunities is still required.

The consideration of ESG factors helps organizations to take a proactive approach in anticipating, avoiding and mitigating these risks.

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\(^6\) How are your climate change disclosures revealing the true risks and opportunities of your business? Global Climate Risk Disclosure Barometer 2018: EY 2018.
## Call for action

**Integrate ESG in risk management frameworks and procedures**

- Develop company-wide processes and structures for managing ESG and climate-related risk related to investment decisions
- Scenario analysis and calculation of emissions reduction paths
- TCFD analysis and support
- Climate risk modelling and construction of the required data architecture
- Tailor made sustainability benchmarks and indices
- ESG due diligence
- Preparation of action plans to achieve compatible emissions targets
- Measure nonfinancial performance (impact measurement)
- ESG maturity scanner
- ESG screening

## Communicating sustainability

Another important step is the communication of the sustainability impacts, efforts and outcomes to all stakeholders in the form of sustainability disclosures. By revisiting the sustainable strategy and risk management approach — outlined in the first two steps — an integrated report allows for communicating these actions in a concise manner. On a meta-level, it fosters greater transparency and accountability, resulting in higher levels of trust in the organization. The assurance of an integrated report facilitates the presentation of a coherent, credible and targeted story of the company's business strategy and operations. From an investment perspective, an integrated report will help inform capital allocation decisions.

## Call for action

**Charting the sustainability communication requirements including adjusting the data management and assurance**

- Preparing disclosures aligned with emerging transparency requirements
- Integrated Reporting (IR) training: introductory and practitioner's course
- Assurance, data quality and assurance readiness checks on KPIs, Nonfinancial Information (NFI) reports and industry guidelines (e.g., Principles for Responsible Investment (PRI))
- Certification of ESG investment products (e.g., green bonds)
- Support in ESG reporting
Conclusion and recommendations

This paper describes the sustainability trends and the impact of these trends on our financial system and on the actors involved. Putting these firmly on the agenda of financial institutions in the capital markets will impact future-proofing the system. The calls to action as described above will help you in taking critical steps forward in this respect. As stated before, the financial sector could, and should play an essential role in leading ESG integration and thereby facilitate better decision-making and long-term value creation. After all, the financial sector as a whole cannot act as if climate change is none of its concern.
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