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Article 173 of the French Energy Transition law

Implications, First Steps and Impact

Aimed at channeling funds to the law on Energy Transition and Green Growth, Article 173 of the law introduces, for the first time, disclosure requirements for asset owners on their management of climate-related risks and, more broadly, on the integration of social and environmental parameters in their investment policies.
This paper takes a close look at the innovative new law that could transform the French responsible investment industry. The law also offers a glimpse to global investors of the possible reporting strategies that they could develop relative to their portfolios.

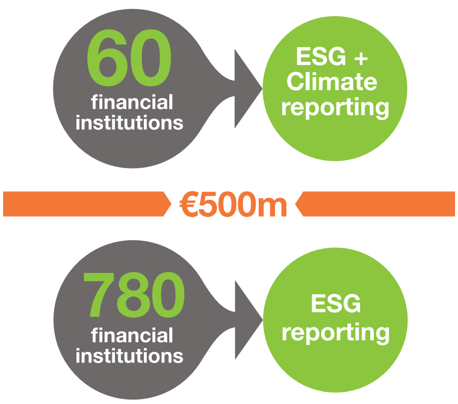
The legislator's intent

Denis Baupin is a French Green MP. As the rapporteur of the French Energy Transition law adopted on 17 August 2015, he added clauses, with the help of his socialist counterpart Arnaud Leroy, that encourage companies, investors and banks to communicate on their management of climate-related risks. Denis Baupin continues to watch over the development of the measures integrated in Article 173 of the law as part of his remit to inform the public on its application.

What was your aim as legislator?
My aim was to give economic interest to what is ecologically essential. The transition to a low-carbon economy is possible only if we can finance this deep-seated transformation. This implies a shift from the financial sector towards a low-carbon economy and that it invests in solutions that foster that change.
The first step forward is to force transparency on fossil fuel emissions generated by companies. This should generate greater awareness and make investors understand their portfolios' exposure to carbon-intensive companies. That is why we have added amendments to the Energy Transition law that encourage companies to publish their emissions, investors to assess their carbon risk and banks to put the topic on their agenda.

What sort of arguments did you face?
Financial lobbies used their classic argument that the competitiveness of Paris' financial centre would be damaged by an exclusively French legislation. The lobbying groups wanted to wait for European legislation, and even global legislation, which would have been a good way of pushing these issues further back. We were lucky to develop the project in a favorable context, with France, the host of COP21, wanting to set a good example. And so our amendments were adopted, and the Finance and Environment ministers upheld this commitment at the COP21.
However, we must remain vigilant to keep the implementing decrees from distorting the intent of the law – something we were watchful of regarding investor obligations. We are also keeping an eye on the decree that deals with company obligations, which has yet to be published. We are also waiting impatiently for the report from the banks to be published by year's end.

Do you believe that French investors are ready to integrate climate risk and, more broadly, environmental and social parameters in their management policies?
The situation is evolving and awareness is increasing because these provisions are linked to upheavals in the energy situation. The coal business model is collapsing while renewable energy sources are surpassing every forecast in terms of development. If this phenomenon is to become massive, we need to find the best indicators to make carbon footprint a clear and visible source of differentiation for investors and companies, as well as for NGOs and the media.
The impact of these measures will be gradual but they stand as proof of a new phenomenon: a mutually beneficial alliance between ecology and finance when both sectors find common ground. ■



→ Climate reporting for large investors

The implementing decree of Article 173 provides for different reporting obligations based on the size of the financial institutions. In total, 840 financial institutions now have ESG reporting obligations. Of these, 60 asset owners, with consolidated balance sheets worth more than €500m, have additional reporting requirements: management of climate change-related risks and their contribution to the financing of the green economy. Only one quarter of them have already made a commitment on climate and/or led a more or less expansive responsible investment strategy for several years. Globally, asset owners will need to significantly change their communication and reporting methods to comply with the intent of the law. ■

novethic

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and the support of Humanis

Who does Article 173 apply to?

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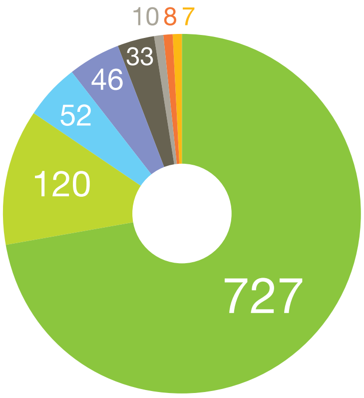
With Article 173, France is the first country to introduce a law encouraging asset owners to integrate climate risk and environmental and social dimensions in their public disclosures. Asset owners in France make up a heterogeneously-organized whole. The category is home to players with extremely different activities and statuses. Consequently, the lawmakers also provided a legal scope for the concept of asset owner: the implementing decree lists categories of institutions subject to a reporting requirement. These include **insurance companies, mutual funds, asset managers, provident institutions and public and private complementary pension institutions regulated by their respective French codes.**

Novethic's research shows that some 840 asset owners will from 2017 be required to explain their responsible investment policy These comprise players of all sizes operating in the fields of insurance (health, life, property and casualty), provident schemes and pensions, together with a range of legal statuses (private, public, mutual).Personal insurance companies, in particular complementary health insurance entities, are by far the most numerous yet are often small structures with limited scopes.

The 430 French asset managers, members of the French Asset Management Association (AFG), are also subject to Article 173. However, they have already had ESG reporting obligations since July 2012 with the application of Article 224 of the Grenelle II law. Foreign asset managers are not impacted by Article 173 but may have to provide ad hoc reporting for their French clients. The French subsidiaries of **large financial groups** are potentially subject to requirements that do not apply to their parent companies. ■

French asset owner's activity breakdown*



* Some of the 840 asset owners may combine several activity.

Asset owners to take the lead

By encouraging a large number of asset owners to publicly establish a policy on the integration of environmental, social and governance criteria in their management, Article 173 of the French Energy Transition law could transform the nature of French responsible investment, of which asset managers today are the principle advocates. It could strike a new balance between forces and encourage asset owners to play a driving role by defining their specifications on ESG integration and climate risk management. One of the initial consequences of this shift could be the development of shareholder engagement, particularly on climate issues. ■

Law requirements for investors

The implementing decree of the law provides an outline of the information requested from asset owners and asset managers. Although it allows investors some leeway, reportings must include the following major categories of information:

■ **A presentation of the general ESG policy** must stipulate the content, frequency and resources used to inform investors, beneficiaries and clients. **Sources of information** used for ESG analysis must be provided, including non-financial data, ratings, reports, and internal and external analyses from the company's reporting.
If the entity has a policy to manage its **ESG risks**, it must describe them along with the internal procedures used to identify and assess them.
Information on the integration of ESG criteria in investment policies may comprise "**distinctions** by activity, asset class, investment portfolio, issuer, sector or any other relevant breakdown".

■ For **asset managers**, it must include a list of the funds integrating ESG criteria, as well as the share of these funds in the overall assets under management, together with any adherence to a specific charter, code, initiative or certification.

■ The **assessment of climate-related risks** must also be explained: main data, climate scenarios used as reference, scope, timeframes and approaches (static or dynamic). These risks shall be **broken down between physical risks** and **transition risks**. The measurement of portfolio footprints, either "past, present or future, and direct and indirect", must also be included. Contributions to national and international objectives on the climate and the energy transition shall also be disclosed. A complete range of methodological choices is also suggested for entities to explain their contribution to the energy or ecology transition: these can be assets invested in green equities or bonds, in infrastructures or theme-based funds which may be subject to green certification (eg. EETC Label) or similar initiatives. ■

ESG and climate reporting : where are we?

Article 173 of the French Energy Transition law, which was challenged in France's highest constitutional authority, the Conseil Constitutionnel, remains a complicated measure for many investors. However, it could lead to the generalization of practices already well-implemented by the most engaged actors in the market.

→ Some 15 large investors are proactively showing the way

More than 10 French investors (asset owners) have signed the Principles for Responsible Investment (PRI). These investors are committed to both integrating ESG criteria in their asset management and publishing reporting on their approach.

In regards to climate reporting, 11 financial institutions impacted by Article 173 have already adhered to climate-related commitments (more than half of them are also PRI signatories). 9 have adhered to the Montreal Pledge, a PRI-supported engagement whereby companies publish the carbon footprint of their portfolios. 5 have adhered to the Portfolio Decarbonization Coalition (PDC) pioneered by the United Nations Environment Programme Finance Initiative (UNEP Fi). Two of them, Axa and the Caisse des Dépôts group, have published reports that focus on their climate engagements. The Axa Group Carbon Footprint 2015 Disclosure describes the carbon footprint of the company's portfolios, whilst the Climate Engagement of the Caisse des Dépôts summarises its financial engagements on the energy transition and decarbonization.The table below analyses the most proactive players. ■

Comparative table of the main existing climate reporting initiatives

	Carbon footprint	Scope measured	Decarbonization pledge	Terms of decarbonization
AXA	284 tCO_2e / \$m of revenue	75% of general assets invested, or €402bn	No specific pledge or quantitative target published	Shareholder engagement Green investments (at least €3bn by 2020) Divestment from coal
Caisse des Dépôts (Group)*	452 tCO_2e / €m invested	Listed equity portfolio (€55bn), scope 1 and 2	20% decrease (equity portfolio) between 2014 and 2020 and 38% decrease on real estate portfolio by 2030. Adherence to the PDC	Shareholder engagement Green investments (€15bn by 2017) Divestment from coal
CNP Assurances	470 tCO_2e / €m invested	Listed equity portfolio	20% decrease of equity portfolio footprint by 2020	Shareholder engagement Green investments (€1.6bn by 2017) Divestment from coal
ERAFP	340 tCO_2e / €m of revenue (16% lower than MSCI World Index)	Listed equity portfolio (€5bn), scope 1, 2 and 1st rank suppliers	Adherence to the PDC	€750m low-carbon index mandate Shareholder engagement
FRR	357 tCO_2e / €m invested (15% lower than a representative benchmark)	Listed equity portfolio (€14bn)	Adherence to the PDC	€2.49bn low-carbon index mandate Green SMEs investments (€20m)
Humanis	444 tCO_2e / €m invested	Listed equity portfolio (€2bn)	2%/year decrease by 2020 Adherence to the PDC	Green bond fund (€125m by end 2015) Shareholder engagement
IRCANTEC	450 tCO_2e / €m invested	Listed equity portfolio (€2.4bn), scope 1 and 2	No specific pledge or quantitative target published	€1bn low-carbon index mandate Shareholder engagement

■ KPIs based on companies' revenue ■ KPIs based on amounts invested ■ Targets of absolute decrease of carbon footprint by 2020

* The carbon footprint and associated scope of Caisse des Dépôts integrates subisdiaries including CNP Assurances and Bpifrance

Climate data implemented in just a few months

The carbon footprint assessments primarily concern equity portfolios and the measured emissions are relevant only for Scopes 1 and 2 (the most direct). However, available reporting shows that it is possible to publish first sets of relevant data on climate risk management. All the reporting responds to the incentives arising from the UN initiative to rally the financial sector as part of the November 2014 climate negotiations. This means that the carbon footprints were implemented in just a few months. ■

Stakeholders **impatiently wait for results**

Article 173 has generated a host of expectations on the part of public authorities and stakeholders. Negotiations on the implementing decrees are intense, particularly those on obligations for companies regarding their direct and indirect greenhouse gas emissions. Yet this data is essential to investors committed to meeting their portfolio decarbonisation objectives.

→ Assessment by **public authorities**

According to the implementing decree of Article 173, the government must review its application after the first two years and before 31 December 2018. A "referential taxonomy" could be set by decree "on the basis of observed best practices". It also provides that the information supplied by asset owners be published "in an easily identifiable way on their website" starting on 1 January 2016 and no later than 30 June 2017 and that the information be updated annually.

The decree also encourages the creation of a code and, as such, the relevant organisations (including AFG, AF2I and French SIF) are preparing works of differing content that could take the form of recommendations or guidelines on best practices. ■

→ Assessment by **NGOs**

■ **WWF**

Pascal Canfin, the new executive director of WWF France, former French minister and an expert in the links between finance and climate, has pledged to make the analysis of reports published by the financial sector one of his NGO's priorities. "We are going to position ourselves to evaluate, when the information is available in late 2016 or early 2017, how the people who manage our savings contribute more to the financing of the transition, how they diminish their climate risk and whether they are gradually adopting an investment strategy that limits climate change to 2°C," he told the AEF press agency.

■ **Group of organisations to measure companies' climate impact**

Association Bilan Carbone, Ademe, Basic, L'Observatoire des Multinationales and the Climate Action Network (France) have pooled **three studies to show that indirect greenhouse gas emissions need to be better taken into account, not only in companies' climate reporting but also in their mitigation strategies**. The organisations emphasize that the volume of indirect emissions generated by financial activity could be 10 to 100 times greater than their direct emissions. ■

Reporting: **instructions**

Stakeholders (primarily NGOs) and the public authorities are waiting for action on the part of investors, but many of them are only now discovering this issue. The following guidelines indicate the main steps investors should have in mind before they implement ESG and climate reporting.

ESG	Climate
Define a responsible investment policy and associated targets: to ensure that the company's investment is consistent with the institution's purpose, to protect its reputation and to answer to the expectations of its clients and beneficiaries. This entails an understanding of SRI basics (management techniques, funds, rating agencies and different methods of analyzing ESG)	**Define a climate policy** whose four main features are: divestment from the most harmful activities such as coal; green financing; decarbonization of portfolios; shareholder engagement
Identify ESG risks: assess Environmental, Social and Governance (ESG) risks that have a clear measurable impact on portfolios to protect the long-term value of assets. Identify controversial companies held in portfolio that may have a negative impact on the investor's reputation.	**Measure a company's carbon footprint:** there are many service providers that compute a portfolio's exposure to climate risks. To do this, the company needs to determine the scope, the method and choose whether or not to join an existing coalition
Define a scope and a timeframe: the development of a responsible investment policy differs whether the management is delegated or internalized; in both cases, this policy starts with shares and is then extended to other types of assets	**Determine the targets to reduce indirect emissions of portfolios:** these can be relative or absolute, they can be linked to stakeholder engagement, divestment or low carbon/green financing mandates
Define indicators to measure impact, or even to measure results: developed in the last fifteen years, ESG analyses enable the creation of social, economic and environmental indicators, such as the creation or the preservation of jobs, CO_2 emissions linked to investments, or the contribution to the local economy	**Define and quantify indicators:** these can take the form of the share of green investments, of climate footprint indicators or certified funds according to the governmental EETC label.