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VH/MM/MK

EACB comments on the European Commission's Inception Impact Assessment on Sustainable corporate governance

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General comments

The EACB welcomes the opportunity to comment on the European Commission's Inception Impact Assessment on Sustainable corporate governance.

Blindness to diversity

Under *"Problem the initiative aims to tackle"* the consultation document refers to the study *"Study on directors' duties and sustainable corporate governance"* provided by EY. According to the information on page 2 the study mainly focused on listed companies, while it generalizes its results in conclusion for all companies.

Most noteworthy, however, is that for the authors the world of companies seems to be composed of companies in different sectors, of different size and of different type, which only implies listed or non listed companies. Based on the findings related to the examination of the behaviour of types of companies the study draws conclusions and makes proposals to the Commission for all kinds of companies without further differentiation.

The study completely ignores that there are different types of companies such as cooperatives or mutual companies, with a different governance structure and aims other than maximizing profit. The diversity of company models is also reflected in the Treaty (Article 54 of the Treaty) and EU law, in Council Regulation (EC) No 1435/2003 on the Statute for a European Cooperative Society (SCE). The latter points out: *"Cooperatives are primarily groups of persons or legal entities with particular operating principles that are different from those of other economic agents. These include the principles of democratic structure and control and the distribution of the net profit for the financial year on an equitable basis."*

We would be less concerned if the study had made a caveat and indicated that it had not examined the situation of cooperatives and mutuals and that accordingly its results would not apply to them. However, this is not the case.

We therefore reject the validity of the study and its conclusions for cooperatives and mutuals.

Furthermore, we are seriously concerned that also the consultation document's policy options do not reflect the diversity of company laws. Like the study it only refers to "companies" in the broadest sense and apparently intends to roll our measures to as many companies as possible.

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We urgently ask the Commission services to correct this approach.

The importance of the consideration of the diversity of existing corporate models and their specific governance

We would like to particularly underline that in its plans the European Commission has to consider the diversity of corporate models and business models and the variety of governance features.

Specifically, the governance model of cooperatives, due to its nature is already well-tailored to reflect long-term oriented and sustainability goals and the views of stakeholders

1. The principal object of a cooperative is the satisfaction of its members' needs and/or the development of their economic activities, in particular through the supply of banking services in the case of cooperative banks. The generation of profit is relevant – like for any other undertaking – but not the primary purpose.
2. Membership is normally open to all citizens living in the business area of the cooperative bank. EACB counts about 58 Million members of cooperative banks in the EU. The aim (and often the reality) is a life-long relationship of the member/customer with his bank.
3. Members vote in the general meeting on the major matters related to the cooperative, generally on the basis of the democratic principle (one member, one vote). There are no "lead shareholders" that drive the policy, but the policy is determined by the community of member/customers.
4. In most cases, membership requires the acquisition of a (limited) amount of cooperative capital. This amount is relatively moderate in most cases. By consequence, the shareholder structure of cooperatives is characterized by very high number of micro-holdings of capital.
5. Remuneration of capital is limited: members receive dividends for their shares, which in some jurisdictions are even subject to a cap. Generally, dividend payments are moderate and stable over long periods. However, usually the biggest part of the profit is transferred to the reserves (retained earnings).
6. Members acquire shares at face value and (when leaving the cooperative) never get more than the face value back (even less in the case of serious losses that depleted reserves). Thus, shares prices remain unchanged over decades, what excludes any speculation with cooperative shares. At the same time, since losses affect retained earnings in the first place, members of cooperatives do not have to fear for their (usually moderate) investments, when the economic environment becomes more difficult. Thus, during the financial crisis, there was no sell-off of the shares of cooperative banks as this was the case for other banks.

The aforementioned factors, everyone for itself, but especially in their interaction, provide for a governance structure that envisages a long-term orientation and customer-focus of cooperative banks. Cooperative banks cannot simply change their business policy or product range or drop certain customer categories. They are not driven by investors to maximize profit, but have to ensure a stable, long-term

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profitability and high-quality services for a large number of owners at reasonable prices in order to ensure their mission.

Thus, the current framework on governance of cooperative banks already reflects ESG aligned long-term horizons and sustainability: long-term view of cooperatives is an advantage from an ESG perspective; the mitigating effects of this embedded long-term orientation should be reflected for future measures i.e.: to enhance (not duplicate) its elements: In addition, we believe that enhanced reporting and disclosure, integration in SREP process, as envisaged in CRR2/CRD5 (Article 449a CRR2, Article 98(8) CRD5), and the reviewed NFRD specifically addressed to the banking sector will also already have relevant implications on conduct and governance. SRD2 already invites institutional investors to disclose long-term objectives and asset managers to comply with such long-term policy.

Any measures being considered by the Commission should thus either not be applied to cooperatives or if this cannot be avoided, in a way that is appropriate to the existing governance structures of cooperatives

Beyond our central concern, we would like to draw your attention to the following topics:

The importance of legal clarity and consistency

In fact, it is very important to make sure that future directives/regulations are consistent with the already existing framework and do not contradict the existing legislation and guidelines (sector specific initiatives such as for example draft ECB Guide on climate-related and environmental risks which is currently being developed for the banking sector). It is crucial to ensure legal certainty and clarity to all market players, and any inconsistences should be avoided.

Performance and Profitability

We question the universality of the statements that *… companies performing well on sustainability factors outperform their peers and are more competitive."* and "*New research about the COVID-19 crisis also shows that companies with better social and environmental performance are more resilient in the crisis."* We would like to point out that the basis of every successful undertaking is a sustainable business model and good profitability. Banks do not master a crisis due to their social and environmental performance, but due to a sustainable business model and profitability. Thus, any approach to the measurement of the performance of companies must not ignore the purely economic ("E") aspects. The approach must therefore be EESG.

Cooperative banks, very often older than a century, are very well aware that only a good profitability will allow them to pursue the member-oriented business strategy and engagement for the communities.

Due diligence duty – scope

The Commission proposes the implementation of a due diligence duty, according to which companies would have to take measures in order to address adverse sustainability impacts in their own operations and in their value chain by identifying and preventing relevant risks and mitigating negative impacts.

We believe that such a supply chain due diligence requirement should apply to companies exclusively with regard to business activities which are carried out outside the EU and only with regard to business relations maintained with partners established in third countries. There should be a general presumption that companies' activities and transactions in the EU are in line with the national law (constitutional/labour law) and EU framework and that they comply with the relevant standards

regarding environment, social and governance aspects. Otherwise the rule of law would be questioned. In the same vein, activities with partners established in countries on a “positive list” from human rights/labour/environment standards perspective should not be covered by the due diligence requirements (e.g. New Zealand).

Measures of a wider scope (covering all business relationships) would implicitly contest the existing EU framework which as such is based on the principles of respect for human rights, civil and labour rights and liability and includes also range of regulatory measures aimed at the protection of environment. A correct implementation of the EU law including the environmental legislation is guarded by the EC and its enforcement is done by the national authorities, supervisors, and EU institutions.

The needs of SMEs (unless they operate in high-risk sectors such as the mining sector or those companies who trade in raw materials or tropical wood i.e. the Swiss Responsible Business Initiative) should be taken into account as especially in the light of the Covid-19 crisis imposing extra requirements may result counterproductive and may effectively demotivate small enterprises to engage in taking up and pursuing an economic activity.

Our members believe that for SMEs such an obligation would be actually extremely burdensome if not unfeasible (in light of the current economic circumstances). Hence, the personal scope of the envisaged due diligence duty (if implemented) should be limited to companies that are subject to the revised NFRD. This limitation of the personal scope would also be in line with the Commission’s commitment in the section “likely economic impacts” of the impact assessment, where the Commission refers to the principle of proportionality and points out that due consideration will need to be given to limiting and alleviating the burden for SMEs, for instance by the inclusion of exemptions from certain substantive and possible reporting obligations and/or by simplified standard(s).

<u>Directors’ duties – a stakeholder approach</u>

Taking into account the social expectation vis-a-vis companies to consider issues such as human rights violations, environmental pollution and climate change in business activity, we share the Commission’s view that that companies and their directors should take account of these interests in corporate decisions alongside financial interests of shareholders. We want to stress that the legal frameworks and corporate culture in many EU MSs foresee already that the management body (with supervisory board in some MSs i.e. two-tier approach) guided by the company's interests, shall define the business strategy in view of long-term interests of shareholders, employees, also a broader business and social context, i.e. interests of its partners and of local communities. Especially in cooperative banks, the perspective is strongly related to local communities and the impact on a longer term.

Moreover, as co-operative banks we would also like to highlight our specific values which are embedded in the ways co-operatives do banking and which in fact reflect the wide horizon of the business strategy developed by co-operatives: solidarity, self-help, fighting against exclusion, social and environmental concerns, resilience, proximity, trust and governance.

<u>ESG risk</u>

At the same time, we would like to underline that the relevant expectations (with regard to the adequate knowledge and understanding of ESG risks, the need to take into account such risks in decision-making) towards banking executives are already being developed in the ECB Guide on climate-related and

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environmental risks. The SSM Guide on climate-related and environmental risks will be in force by the end 2020 (expecting to consider taking a forward-looking time horizon for environmental risks fully anchoring to the ICAAP).

With regard to proper risk management, the framework, which is being developed for banks also takes into account ESG, aligned long-term horizons and sustainability: CRR2 & CRD5 (Art. 98 CRD5), shall result in the presentation of a complete ESG-framework in 2021.

Beyond this, there are however indeed some very specific areas and provisions, where the current regulatory framework does not seem sufficiently aligned to support a long-term perspective:

- The current accounting treatment for equity instruments under IFRS 9 discourages companies from undertaking new long-term investments in equities.
- The prudential framework (Basel 4, CRR2 and Solvency II) also discourages Long Term investments/financing by imposing high risk-weight for long term exposures (including equity). In particular, the Basel 4 treatment of specialised lending will be detrimental to project finance.
- We believe that the conditions of Article 501a CRR2 (so-called infrastructure finance factor) are far too restrictive and are not in line with market realities. We thus advise to review this provision.
- Adequate information from all corporates would allow banks to assess customers' progress along the transition path, incentivising a longer-term perspective also on borrowers' side. This however requires a much-differentiated framework for micro-companies, small companies, and medium/larger companies, based on a common methodology. For smaller companies, this should in a first phase remain a voluntary exercise; a phased approach could ensure that gradually they are able to produce relevant data on a permanent basis.
- Solvency II is sensitive to markets and interest rates levels (mark-to-market), discouraging long term investing particularly when rates are at or close to the zero bound (i.e. small shifts in the interest curve can have a proportionally larger impact).

Directors' remuneration

The Commission proposes other possible corporate governance arrangements for example regarding directors' remuneration (without providing further details in the impact assessment).

We assume that the Commission envisages a new remuneration-requirement, according to which a mandatory share of variable remuneration should be linked to non-financial performance for corporates and financial institutions (as suggested in the consultation on the renewed sustainable finance strategy).

We are of the view that it must remain the responsibility of the financial institution to decide what share of variable remuneration relates to non-financial performance. Furthermore, we think that this solid linkage between the non-financial performance and the remuneration does already exist in the current supervisory framework (CRD IV, GLs on sound remuneration policies, Disclosure Regulation).

CRD IV, the EBA GL on sound remuneration policies and the ECB Guide on climate-related and environmental risks take a very holistic approach regarding remuneration and in our view stimulates sustainability-oriented behaviors in banks. We are of the view that the current framework ensures that sustainability targets will be reflected in the banks' objectives and business strategy. Those aspects would have to be considered as company values in variable remuneration while this in turn will encourage

behaviours consistent with the ESG aligned approach of banks' staff and management. Hence, an overrepresentation of ESG targets should be avoided as it could have a destabilizing effect.

Finally, we would like to underline the current already very complex legal framework on remuneration: in fact, since there is no comparable remuneration regulation in other industry sectors, financial institutions are at a significant disadvantage on the labour market when it comes to meeting applicants' remuneration demands or to retaining employees by variable remuneration. We believe that adding an additional expectation for banks to consider implementing a variable remuneration component linked to non-financial performance for financial institutions sounds burdensome and may result in practical difficulties on the side of banks to make those payments.

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