INSTITUT MONTAIGNE

COMITÉ MÉDICIS

Responsible Capitalism:
An Opportunity For Europe

REPORT SEPTEMBER 2020

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There is no desire more natural than the desire for knowledge

BUSINESSES, NATIONS AND EUROPE IN A CORONAVIRUS WORLD

By Yves Perrier and Jean-Dominique Senard, joint presidents of the working group

The coronavirus pandemic plunged France, Europe and the whole world into an unprecedented crisis. Economies, businesses, stock exchanges have been brought to a halt. National governments worldwide have adopted exceptional measures in an attempt to prevent economic and social collapse, in the hope that the world we once knew would be reborn. But history nor economies never really stop. The major geopolitical balances will be modified, States will be playing a new role, and for a long time, and businesses, at least those who survive the crisis, are viewing this new horizon with uncertainty over what to produce, how and for whom. Who can predict how public opinion will be affected in the aftermath of this ordeal? The recovery period will be a time of new foundations. The new circumstances that are emerging must be viewed not so much in reference to a past to be recreated as a future to be built.

Countries have resisted thanks to the solidity of their institutions, particularly the European institutions, including the European Central Bank (ECB), and a tidal wave of dedication, starting with that of the medical sector, but also from countless unnamed individuals, associations and businesses. The combat is now being fought by businesses, which have the huge responsibility of winning the fight. During the lowest points of the crisis, Nations resisted, largely thanks to their doctors and healthcare systems, but the time has now come for businesses to step in. This mission will bring them new purpose.

This is a decisive moment for businesses, which are finding themselves suddenly responsible for ensuring the recovery of the Nation, and all its economic and social assets. It is their responsibility that is being put to test and particularly their capacity to fulfill the social function that they have previously professed. They cannot, of course, bear sole responsibility without being assisted by the public authorities, social partners and all their stakeholders. Business cannot, of course, replace the political system whose legitimacy is rooted in democratic elections. The responsibility of businesses will be engaged in three main areas: health, solidarity, and sovereign power and independence. The confidence placed in them by society is at stake. And the future form of our countries' economic structure (market-based, planned, administrated, etc.) depends upon them.

Companies have needed the trust of their employees and union organizations to be able to resume their activities. This activity will be organized under their joint responsibility to ensure the best possible health and safety conditions. Mutual trust must be restored between employees, collective labor relations must be re-created – without these, there will be no businesses.

The epidemic has made solidarity the core value for nations once again; this is particularly clear in the supportive and recovery measures taken by the public authorities. These are designed to guarantee the survival of all businesses, both those receiving the aid directly and those that do not apply for the measures proposed but benefit from the rescue of "ecosystem". One aspect of a company's purpose is to contribute to the smooth operation of Society as a whole; this is one aspect of its mission. The principle of solidarity will be at the heart of the reconstruction and will define the scope of business responsibilities in the long term.

This dimension of solidarity brings us back to the Nation. Health protection can, and probably even should, be coordinated internationally but only exists on a national level in territories defined by borders within which a sovereign power can be exercised. Once again, the countries have experienced the extent to which, under such circumstances - and even in Europe - they must count on their own assets. During the reconstruction phase, while rebuilding their own

activities, companies will have to contribute to the fundamental political mission of ensuring the independence of the Nation. Globalization will not be stopped but it must be governed so that its exchanges ensure the independence and resilience of the Nation. This will be one of the responsibilities that falls upon companies.

Reconstruction must be an opportunity for a New Deal between businesses and the Nation. The Nation must be able to count on responsible companies, able to implement the recovery under good conditions, to show solidarity with all stakeholders and to organize themselves so as to ensure the independence of the Nation. The definition of this New Deal had actually already been outlined with the notions of "corporate social responsibility" and "responsible investment", and, more generally, "responsible capitalism". A model must be built that can offer prosperity while responding, at the same time, to the major challenges of global warming and social divisions. Today, it must also include the responsibilities of a reconstruction in which businesses will be the leading players, ensuring that health, education, economy and social aspects can once again function together. The public authorities must propose measures to encourage investments and large-scale innovation programs. Today, this New Deal appears to be the fundamental condition, the very principle, of the reconstruction.

This New Deal, first and foremost, falls within the competence of the Nation. Each Nation must choose the type of well being that it wants for its population, along with the conditions of its independence and sovereignty. However, for Europeans, implementation will depend upon it being integrated into the policies of the European Union (EU), to which they have chosen to belong, specifically as a means of ensuring their prosperity, independence and resilience. The "responsible capitalism" New Deal must be part of our treaties, just as the social market economy was originally. At a time when our future once again depends on businesses, it would be difficult to comprehend if the Commission failed to make this one of its main concerns. Shortly after it was formed, the Commission voted a Green Deal that aims to make the EU the world's first carbon-neutral economy. However, challenge is to respond to the issues of the social crisis and the independence and economic resilience of Member States while including climate and environmental requirements in this response at the same time.

Europe must protect its borders by setting a price on carbon. Faced with Covid-19, the European institutions succeeded in overcoming many budgetary and financial constraints that were not adapted to this exceptional period. Last July, the European Council was able to break the taboos of budgetary solidarity in order to finance a powerful recovery plan. We must continue these efforts and review the measures and provisions that prevent or discourage Europe from becoming the land of responsible capitalism – and abandon or reform them if necessary.

The “responsible capitalism” issue must be the underlying principle of a new, reformed EU, which has become essential. The Union depends upon three pillars, the first of which is business. We have just described the responsibilities and purpose of companies in the current context: to ensure economic recovery in the best possible health conditions, to show solidarity with their stakeholders based on similar values, to generate resilient and sustainable prosperity. The second pillar is financial: the investors making long-term commitments to businesses that accept their social responsibilities. The third lies in the set of values that determine corporate responsibility in the European sense: these values include the social aspects of solidarity (prosperity must concern everyone), resilience (through the attention paid to protecting the planet) and independence. To allow these values to express themselves, the accounting and prudential standards, inherited from a time when short-termism reigned free, must be reformed and completed with homogeneous extra-financial information on companies’ actions in favor of society and the environment. However, the question of companies’ financing is even more fundamental and lies at the heart of the New Deal as the condition of its feasibility. For European responsible capitalism to exist, European companies must be able to find most of their funding in a powerful European ownership that believes in the social values of a European company. In the current fragile situation, companies will be protected by public actions, or at least this is to be hoped. However, such protection can only be temporary, which means it is crucial that the issue of the composition and destination of European savings be brought back to the table and made a priority, starting right now. This is a question of public salvation because it concerns national and community independence.

The question of social contracts comes up rarely in a country’s history. It happens after revolutions or wars. We are currently in such a situation: to fight the epidemic, to protect ourselves and one another, our governments have had to suspend our normal living conditions; such measures are exceptional because they concern the very survival of the social body, both biologically and politically speaking. Such periods represent a fracture, an interruption, a break in our national history, the extent of which is experienced by every individual attempting to imagine life after the crisis, and therefore the corresponding social contract. One thing is sure, this contract will have to be implemented by companies, each in their own way, in France, in Europe and throughout the world, and so that this new contract is less between individuals, as it was before, and more between companies and the Nation. The restoration of our abilities, our well being and our freedom depends upon companies. This restoration is one of the multiple responsibilities involved in the reconstruction. In our think tanks, Comité Médicis and Institut Montaigne, we have worked on defining the conditions of this reconstruction. We are proud to present the results of this effort, which must mark the beginning of a movement to mobilize the business world. Yes, this new period will be that of a New Deal between the Nation and its businesses, a deal based on the concept of responsibility.

PREFACE

The notion of "responsible capitalism" encompasses much more than just responsible companies or responsible investments. When talking of "responsible capitalism", aside from the unique behavior of certain companies and certain financial players, we are aiming for an economic and financial model or paradigm, a form of relations between the financial world with its investors and asset managers, on one side, and the economic world, i.e. companies and businesses, on the other – an equivalent for the coming years to what financial capitalism has been, i.e. the model adopted by globalized capitalism from the 1980s onwards.

The call for economic and financial players to be "responsible" is therefore far from new. In our recent history, it dates back to the 1990s, with the Brundtland report (1987), which proposed the notion of "sustainable development", and the Rio Earth Summit (1992). Thus came about the idea of the corporate social responsibility of companies and, along with it, that of socially responsible investment (SRI). This movement gained pace during the 2000s, within the framework of the UN (Global compact, PRI), which is also when the European Commission launched its own series of initiatives. Globalization is not questioned and financial capitalism remains the model but shareholders and company directors are asked to consider the long term, to reduce their negative externalities and to adopt ethical behavior in the exercise of their ever-growing power.

Such practices have provided the fertilizer for what has now developed into responsible capitalism, which is not only a moral backing for financial capitalism, but an alternative model: a new face of capitalism, a new political economy.

This form of responsible capitalism is organized around four main points:

1. A *doctrine*, a vision of the company that goes beyond the theory formulated by Milton Friedman in the early 1970s, which states that companies' social responsibility is to generate profit. This principle was associated with a whole series of other formulas, setting out that i) shareholders own the company - and the company must therefore be governed according to their interests -, and ii) the production of shareholder value is the main purpose of the company. Responsible capitalism implements another company philosophy, which is best expressed in the notion of "purpose". It views the company from its social function and the value it brings to all of its stakeholders: employees, customers, communities, conservation and maintenance of joint assets, as well as shareholders, of course. **Responsible capitalism is a capitalism of "purpose".**

2. A *challenge:* financial capitalism has been a program of rationalization and efficiency. Capitalist companies and institutions (particularly political ones) had to be reformed so that companies, which had previously been hampered by the restrictions of national regulations, could wield their true power, enjoy their full potential of invention and innovation, and create wealth and profit. Social and environmental issues were taken into account only to the extent that they did not obstruct business… but the social and environmental situation has become untenable, with the climate emergency on one side and ever-increasing inequalities and social revolts on the other. Responsible capitalism must make capitalism sustainable. Its responsibility is to rise to the challenge of capitalism's "sustainability" by responding to both climatic and environmental challenges as well as social and, more recently, health cohesion. All this must occur in a context that tends to result in a re-nationalization of economies. **Responsible capitalism is proposed as the transformation of our economic and financial institutions that is required for the market economy to survive in the context of these huge challenges.**

3. The *alignment* of shareholder interests with the company's purpose: responsible investors feel committed to these social, climatic and health

challenges. They are aware that the value of their assets depends upon them. Where yesterday's shareholders were constantly seeking greater financial reward, a reward monitored on a quarterly basis, tomorrow's companies will be examined with the same level of attention in terms of their compliance with environmental, social and governance (ESG) criteria, which also contribute to their present and future profitability, and respect of their purpose. **What will be evaluated and assessed is what the company produces in the long term, in all senses of the word: what it contributes as well as what it destroys, all of its positive and negative impacts, its usefulness.**

4. A *political context* marked by two phenomena in which corporate responsibility takes on new meaning. Firstly, the institutions that once defined and normalized collective life (family, religion, army, political parties and ideologies) are becoming weaker; secondly, the Nation is distancing itself from companies, which, thanks to this withdrawal and the influence they have acquired through the globalization and liberalization movements of the past few decades, are becoming the true holders of power. **In this context, the large industrial and financial corporations are being invited to step into the gap and take on responsibilities that can only be described as "political".** Companies, at least the largest ones, are becoming active participants in the defense of public interests, even though public regulations are still pending.

These elements go together. They define a new era for the responsibility of economic and financial players, that of responsible capitalism.

In principle, Europe should encourage the implementation of responsible capitalism within its borders for a number of reasons. The first is one of culture and history. The style and orientation of "responsible" capitalism is clearly similar to the "Rhine model" of capitalism theorized by Michel Albert in the early 1990s, in opposition to Anglo-American capitalism, which he predicted would ultimately dominate, in spite of its failings. Responsible capitalism is based on the "social market economy" concept, the foundation of the European Union's original treaties. **By becoming the homeland of responsible capitalism, the very essence of Europe will be revived.**

However, to implement this program, Europe must fight two major battles:

- The first is a battle of rivals. Responsible capitalism and the theme of responsibility are now promoted worldwide, in English-speaking countries, even in China. From this point of view, the new orientation adopted by America's largest capitalist players since mid-2019 is remarkable: the *Business Roundtable* statement expanding the purpose of a company from shareholder value to include all stakeholders; commitment by asset managers to generalize the principle of responsible management, topped by the publication of a new extra-financial analysis grid at the latest Davos summit. The signals are clear: the world will not be divided with financial capitalism on one side of the Atlantic and responsible capitalism on the other. Future battles will be fought within this new paradigm.

- The second is that Europe, the land of the "social market economy", has allowed itself to be overtaken by economic dogma that have made it kind of a stranger to itself, the imposition of ***fair value*** accounting rules (see part 1.B.2) being a paradigmatic example. The boom in responsible capitalism is, in fact, a fantastic opportunity for Europe, an opportunity to rejuvenate itself, to get back its original inspiration and purpose: to form an area which ensures both its Member States and companies the independence and identity that are necessary to survive when faced with major geopolitical players.

In this report, we have chosen not to focus on the question of corporate responsibility, which has already been widely researched and investigated, but **to concentrate on the somewhat neglected issue of the financial instruments, mechanisms and institutions that hold the keys to such a project.** To be responsible, a company needs shareholders that understand and believe in it. This report therefore proposes recommendations to make Europe the land of responsible capitalism based on three key issues:

1. *Companies financing*, i.e. the capital required to create a sufficiently abundant and stable European shareholding to allow responsible companies to develop (part 1);

2. *Accounting, financial and extra-financial information*, a key issue that determines how capital flows will be directed (part 2);

3. The *legal framework* that Europe must encourage to institute this new capitalism, prevent competitive distortions and protect its companies (part 3).

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I

FINANCING RESPONSIBLE EUROPEAN CAPITALISM

The transition or return to responsible capitalism in Europe requires financing for the economy, in lines with the European values of corporate social responsibility (CSR). Responsible companies, i.e. those that, being aware of their social and environmental responsibility, adopt an approach to define their purpose, obviously need long-term, stable financing for their capital.

The first priority is therefore to encourage long-term financing, i.e. investments whose profitability is not measured on a daily basis but evaluated over several decades. These long-term investments correspond to the needs of Europe's infrastructures, which have been neglected since the 2008 crisis: regional development, health, education, energy, transport. Long-term investments are also those that could make the climate transition a reality. Such needs are also urgent from a political standpoint, to resume the convergence of the economies of European countries and restore faith in the European project. They are also necessary to prepare Europe for the aging of its population, i.e. the ultimate contraction of its active population.

There are two kinds of long-term investments: the stable company capital of companies and the public funding allocated to long-term employment. In Europe, the funds available for investment in companies are monopolized by short-term objectives. Thus, household savings are massively invested in public bonds, which are the counterpart of national debt and deficits[1]*. Furthermore, the prudential rules imposed on savings collectors prevent them from using household savings for company shares. Finally, the savers' preference for liquid savings solutions, even if their profitability is low, illustrates their impatient behavior and fears related to deteriorating social protection and employment conditions.*

Although financial flows in Europe are sizable, because household savings are high, the financial markets in the strict sense of the term, i.e. the markets that direct household savings to companies and long-term employment, are very small.

This creates fragility for European companies, thus falling prey to foreign pension and investment funds, with short-term profitability objectives and no strategic vision for the companies. Consequently, in 2008-2020, the market observed a worrying acceleration in equity investments (even in sectors considered strategic), an acceleration in relocations and financialization of the economy. Under the effects of fair value and the generalization of the lever effect, this led to a speculative frenzy that destroyed many European companies, having a huge impact on social cohesion in many countries and increasing inequalities. Furthermore, this situation is totally incompatible with the challenges of financing the energy transition.

Solutions exist for a new financial structure, enabling us to move away from this short-term capitalism and return to the ideals of a responsible capitalism in which the desire for enterprise is seen as an unfettered desire to join forces to create value in all areas: material, social and environmental.

First of all and wherever possible, we must abandon the regulatory frameworks and accounting rules that are too favorable to financial capitalism, including fair value and solvency rules for financial intermediaries, which do not correspond to the values of European responsible capitalism.

Then, we must create the infrastructures of a truly efficient financial market, with sovereign power in Europe. The first idea is based on the construction of a single financial market in Europe that is coherent with the economic power of Europe and its needs. This Capital Markets Union has been a political goal of the Commission for ten years and is now back on the community agenda once again. This, after Brexit, is a priority.

1 Institut Montaigne, «*Rebondir face au Covid-19 : relançons l'investissement*», *(Bouncing back from Covid-19: let's revive investment)*, Éric Chaney, May 2020.

The second idea, more original and probably less accessible in the short-term, consists in campaigning for a sovereign European pension fund to invest in responsible European companies with long-term projects. A European pension fund would offer the advantage of ensuring solidarity for an aging Europe and building a major sovereign fund rapidly. It could be managed according to Scandinavian or German examples, i.e. shared between the social partners, with mutualist governance.

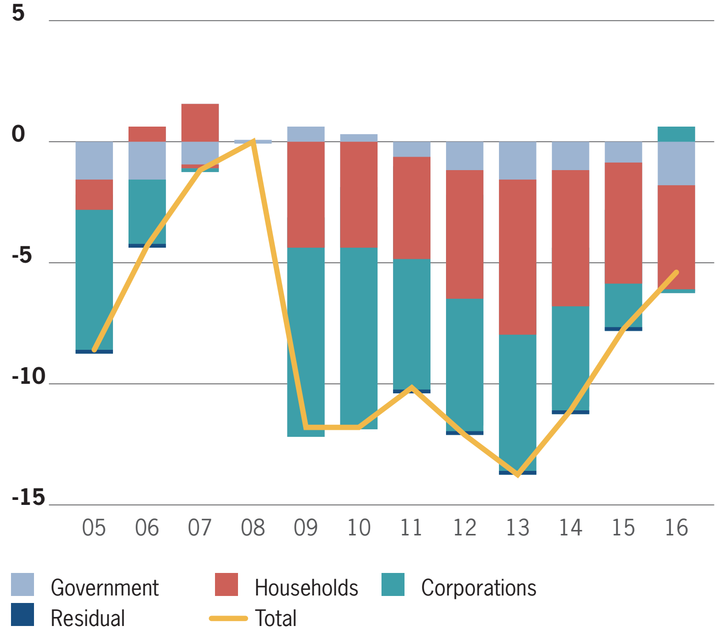
Once these infrastructures have been defined, financial instruments that respect CSR objectives exist and are already proposed by European asset managers. To facilitate and complement investments in companies, the development of instruments such as private equity could be strongly encouraged, providing a protective European framework for savers. Finally, it is urgent to encourage short funding circuits on a local level for micro, small and medium sized enterprises, to enable better use of the abundant savings of pensioners and renew growth in the regions.

The wealth, financial engineering intelligence and skills in Europe are such that there is no doubt that if the regulatory frameworks are defined, many new intermediaries and innovative products will be developed. All these vectors benefit in a way from the aging of the population and therefore the stability of high savings rates; they will also benefit from a risk-free context of low interest rates and therefore the relative ease of directing savings towards more attractive instruments, even if these are less liquid. In short, Europeans must invest in their future and this is perhaps what will finally enable the Euro to become an international reserve currency.

A. Savings and investment in Europe today

There is a European paradox surrounding savings and investments. Savings rates are very high in Europe – although variable from one country to another -, much higher than in the USA. And yet, the American financial markets are five times larger than the financial markets of the Euro zone. In spite of the high savings rates, private investment has not returned to the level it had attained before the 2007-2008 crisis. The same is true of public investment.

Figure 1: contribution to investment of each institutional sector, as a % of change compared with the 2008 level



Author's note: For exemple, in 2016, investment is 6 points below 2008 level, with a slightly positive contribution from business investments and negative contributions of approximately 4 points for household investments ans 2 points for public investment.

Source: EIB, "Investment Report 2017-2018", 2017

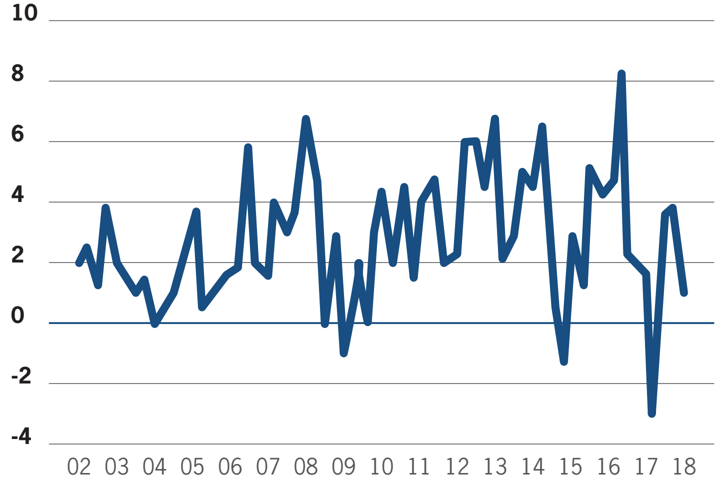
At the same time, and since the 2007-2008 crisis, direct foreign investment in European countries has never been so high. **45% of all assets of quoted companies are held by non-European capital, 33% for unquoted companies[2].** In 2007, these figures were 10% for quoted companies and 20% for unquoted companies.

It is mostly large corporations that attract foreign investors: on average, the quoted companies controlled by foreign capital have eight times more capital than domestic companies. More than 35% of the capital in sectors such as mines, energy, pharmacy, financial services, asset management, insurance and reinsurance, now belongs to non-European organizations. Furthermore, more than 18% of jobs are in companies controlled by non-European capital[3].

The massive proportion of direct foreign investment in Europe held by the USA and Canada (62% of foreign assets invested in Europe) is accompanied by the emergence of new investors, including China (approximately 3%) and offshore financial markets (almost 4%).

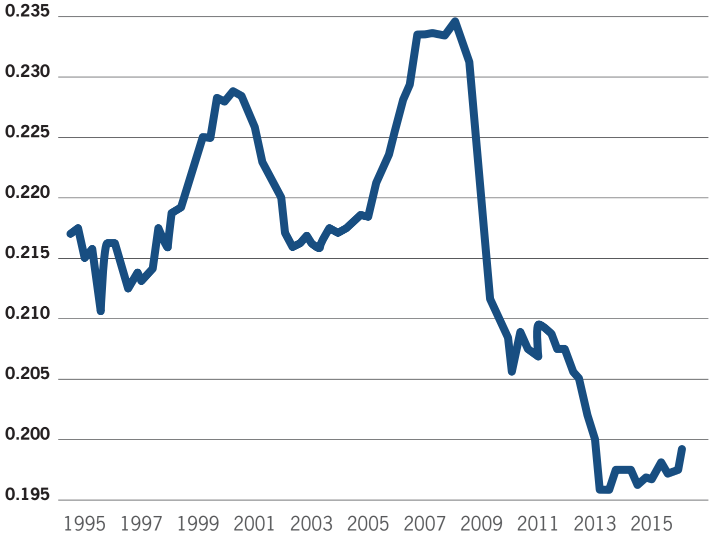
2 Insee, *"Tableaux de l'économie française"* (Overview of the French economy), 2019.
3 Grégory Claeys, Maria Demertzis, Konstantinos Efstathiou, Inês Gonçalves Raposo, Alexander Lehmann, David Pichler, *"Analysis of developments in EU capital flows in the global context"*, January 2019, Bruegel.

Figure 2: direct foreign investment entering the Euro zone between 2002 and 2018 (% of GDP value)



Source: Datastream, Eurostat and Natixis in Patrick Artus, "Une zone euro protectrice, interventionniste, social-démocrate : est-ce une bonne idée ?" (A protective, interventionist, social-democratic Euro zone: is this a good idea?), AFSE blog, 2018

Figure 3: investment in Euro zone companies as a % of GDP (nominal investment/nominal GDP)



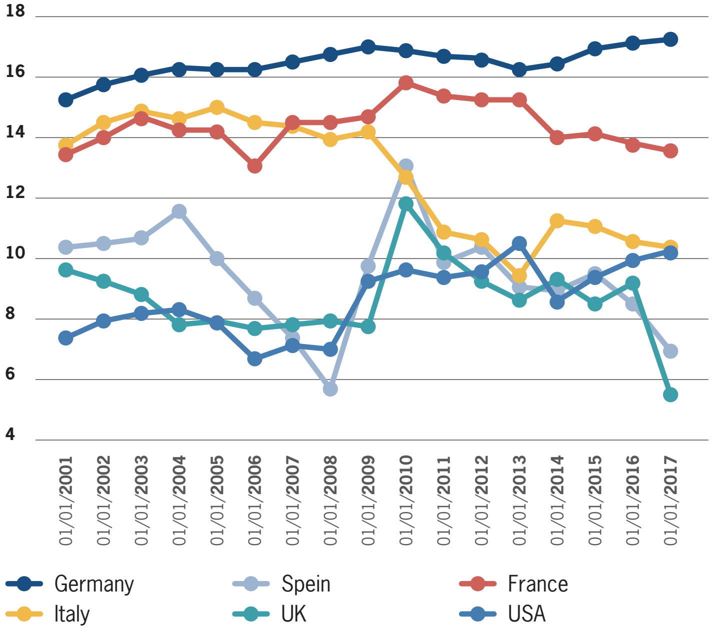
Source: Eurostat, "Investment share of GDP by institutional sectors"

This attractiveness also corresponds to a need: firstly the amount of public debt captures household savings and, secondly, the massive funding of pay-as-you-go pensions reduces the amount of household savings invested in companies.

With abundant savings but very low levels of investment and company financing needs balanced by direct foreign investment, a structural imbalance has developed in Europe and there are no signs that this will decrease. Shares held directly only represent a small proportion of the financial savings of households in Europe. Quoted shares held directly by European households fell by 12% in 2018, according to the Observatoire de l'Epargne européenne (OEE)[4]: households held €1,048.4 billion in shares at the end of 2018 in Europe. German households remain the largest holders with €293.9 bn, ahead of the French (€245.9 bn) (see figure 4). In France, 12% of the mean average financial assets (€60,786) are invested in shares and investment funds, including less than half in direct shares. Deposits (33%), along with life insurance contracts and pension funds (45%), represent the largest proportion of the financial assets of European households (see figure 5).

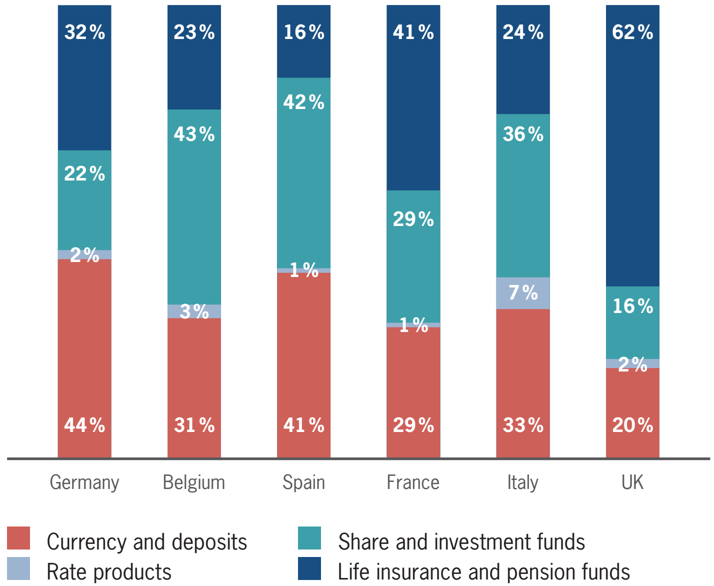
4 Observatoire de l'Épargne européenne, *"Overview of savings in Europe http://www.oee.fr/files/tableau_de_bord_2018_t4_-_faits_saillants.pdf, 4th quarter 2018"*, 2019.

Figure 4: savings rate of households as a % of gross disposable income



Source: Le Cercle de l'Épargne, "À la recherche de l'épargnant européen ?" (Seeking the European saver), 2019 based on Banque de France and Eurostat statistics

Figure 5: % composition of the financial assets of households



Source: Le Cercle de l'Épargne, "À la recherche de l'épargnant européen?" (Seeking the European saver), 2019 based on Banque de France statistics

This situation has proved to be very dangerous for European companies. Firstly because their governance is weakened by the possibility of being taken over by activist funds, with seemingly limitless resources. Secondly, because their need for capital comes up against the difficulty of finding long-term investors, in spite of an abundance of liquidity, who are willing to take a risk on entrepreneurialism and not just on financial assets. Finally, the lethargy of the domestic market makes companies extremely sensitive to the international situation and the industrial GDP of the Euro zone fell by 3% during the last quarter of 2019.

At the same time, the situation for households is also difficult with a negative trend in salary/profit ratio in many European countries, and a persistently high level of unemployment in others. The social crisis is apparent in all European countries and is a root cause of increasing political radicalism.

This creates a paradox: the countries with the best social protection in the world are also those with the highest rates of savings and which place these savings in very low profitability products. This paradox causes entire segments of the European economy to fall under the control of foreign investors, which are looking for profit and are therefore activist funds.

Faced with this situation and the current doubts concerning financial capitalism, there is a strong temptation for a European recovery policy, particularly one that favors energy transition investment needs (see 1.E.2.). While its purpose – restoring growth in Europe while encouraging the energy transition – is not really under debate, the methods adopted will not be without effect for European companies. Thus, European financial protectionism would be risky because it would deprive an aging Europe of savings from young countries. Similarly, a recovery policy funded by massive public debt would temporarily attenuate stagnation, but presents the risk of increasing the tax burden, which is already heavy in Europe. This suggests that from the companies' point of view, the remedy would be worse than the disease and prevent them from standing up to global competition and gaining market share. **The main problem for European companies is not having easy and inexpensive access to long-term investments.**

Aging of the European population

In 2050, the world ratio of over 65s to active population will be 58%, compared with 20% in 1980. In Europe, by 2060, the active populations of Greece, Lithuania and Poland are expected to have decreased by 35%. Active populations will fall by between 30% and 20% in Germany, Spain, Italy, Portugal, Hungary, Slovakia, Austria, Czech Republic and the Netherlands. France, Belgium and Finland will see decreases of less than 5%. Only in Denmark, Ireland and Sweden will the active population actually increase slightly, by approximately 3%, as in the UK[5].

These sudden changes are affecting all countries throughout the world. Thus, over the same period, the active populations in China and Russia will decrease by 30%, although a 20% increase is expected in India.

There are many consequences of such changes; the most obvious is a large tax burden to compensate the smaller active population and growing charges, while the costs of healthcare related to long-term care will increase. Finally, a secular decline in the growth of aging countries is to be expected since it is unlikely that productivity, which has been stagnant for 20 years, will be able to compensate the decreasing active population.

However, the aging of the population, if associated with a fall in interest rates and growth rates, is an opportunity to increase savings rates. We must therefore make sure that these savings are oriented towards productive investments, rather than allowing the accumulation of dead assets and low-profitability financial investments, even when pensioner incomes are lower than those of the population.

However, European savers are not necessarily financially educated and refer to strong intermediaries for guidance when building a portfolio. The rate of employee profit sharing in companies is low and the distance between savers

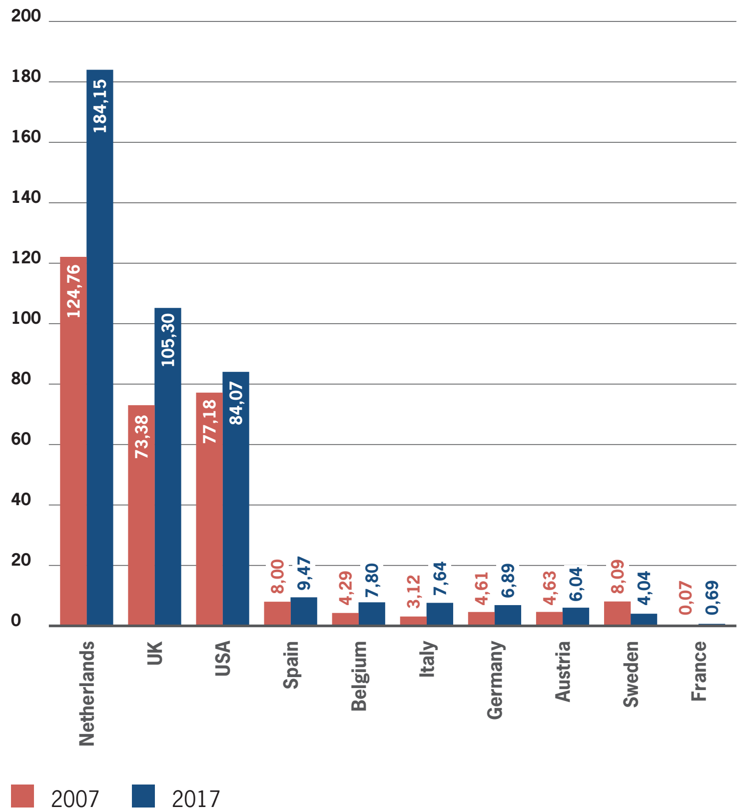
5 Jean-Hervé Lorenzi, François-Xavier Albouy, Alain Villemeur, *"L'erreur de Faust, essai sur la société du vieillissement"* (Faust's error, an essay on the aging society), March 2019.

and the use of their savings is large. Furthermore, European savers are accustomed to evaluating savings products on the basis of their security and liquidity, i.e. availability. Profitability, if it comes with capital risk, is not generally favored. Finally, the psychology of European savers is also dictated by the size of their real estate assets, which cover their motivation to pass on wealth to the next generation, and the extent of social pension transfers (13.8% of GDP in France). These two elements contradict strict application of the life-cycle theory and attenuate the perceived need for long-term savings invested in the productive sector.

Life insurance and financing pensions

Life insurance, and notably contracts in Euro, are experiencing some difficulties; this particularly French problem is also relevant to pension fund management. For European households, the main financial question is that of pensions in a situation of very low or negative real interest rates. Mutualist or joint management of pension funds, which is the method adopted by many European countries, offers a different perspective and greater attention to the social and solidarity economy, but it does not change the basic rules. The companies committing to profound transformations of their business models in order to attain ESG targets need loyal investors and shareholders, in spite of lower short-term profitability. How can we meet this need to develop the loyalty of long-term shareholders?

Figure 6: pension fund assets as a % of GDP



Source: Le Cercle de l'Épargne, "À la recherche de l'épargnant européen?" (Seeking the European saver), 2019 based on OECD data

To redirect household savings to more risky assets, powerful motivation drivers are needed; these might be tax-based, for example, or of any other kind. If the savings of aging households are invested in local projects, they are subject to less volatility and their return is maximized due to the production of well-being.

However, local investment needs in terms of infrastructures, distribution, health services and similar, remain high throughout Europe. These are amplified by significant demand for short, integrated circuits and by the current trend in favor of the circular economy. Thus, 43% of European consumers consider that preferring local consumption is a priority, according to a study by the Cetelem observatory in 2020. Instruments exist to encourage and promote this new investment target (private equity, crowdfunding, ETF[6], ELTIF[7], etc.) (see 1.C.3.).

The coincidence in the two areas of transition, i.e. environmental and social, could be considered when thinking about the need to act immediately on long-term challenges.

RECOMMENDATION: using primarily the savings of European households and companies to finance responsible European companies, by exploiting the coincidence of the environmental and social transitions.

This will involve:
- Reforming the prudential rules of insurance companies;
- Benefiting from the aging of the population to steer pension savings towards responsible assets;
- Setting up an extensive European pension system based on a proportion of existing savings invested in the environmental transformation;
- Giving responsible investments a strategic aspect that could limit, prevent and control extra-European equity investments.

6 Exchange Traded Fund.
7 European long-term investment fund.

RECOMMENDATION: investigating the creation of a European pension fund, collecting a portion of household savings and complementing national pension funding solutions. Such a mechanism would allow for Europe to adopt a unified approach to resolving issues of old age. This sovereign fund would be invested in the long-term in responsible companies, with governance rules inspired by German and Swedish funds (joint or mutualist management, priority given to responsible investment, civil society representatives).

Such a fund would enable a portion of the long-term savings of households to be invested in responsible companies.
A system like this would gradually complement life insurance schemes in countries where such schemes are massively used by savers for pension purposes.

B. A financial inventory in Europe

1. Prudential standards in a post-crisis context

The **prudential standards** are “security” (“prudence”) requirements imposed on companies to ensure their solidity, this solidity being necessary since failure would be disastrous for the sector in which they operate[8]. These security requirements apply mostly in the banking and insurance sectors.

After the 2008 crisis, international prudential standards endeavored to reinforce the solidity of the financial system. New prudential rules for insurance companies and banks were introduced to protect savers and insured parties against the risks of market reversals that might affect the solvency of financial institutions. These came hand in hand with a desire for financial transparency

8 Journal of Regulation and Compliance, *“Normes prudentielles / Bâle II, Bâle III” (Prudential standards / Basel II, Basel III)*, Marie-Anne Frison-Roche, 2016.

that resulted in the generalization of **mark-to-market rules**[9]**,** thus gradually replacing book value[10] practices. This desire for financial transparency also enabled the generalization of risk modeling so as to calculate **values-at-risk (VAR),** which quantify the financial risk of a company.

In practice, these measures have gone a long way towards shortening the horizons of company governance and management and increasing market volatility. Furthermore, in the current context of low interest rates, these rules and their generalization to the European context have led to macroeconomic difficulties:

- Exaggerated investment of household savings in risk-free assets, i.e. public debt;
- Fragility and volatility of company capital, making businesses vulnerable to acquisition by large non-European groups;
- Due to low interest rates, higher expectations in terms of company profitability.

Transparency has increased short-termism and prevented long-term investments[11]. In particular, this financial cycle has made it more difficult to invest in the long-term in the transformation of production facilities to enable them to achieve their environmental and social objectives. Even worse, the governance objectives have suffered due to the desire for short-term financial profit.
In a Europe characterized by the aging of its population, it is as if the economy has been behaving like an inverted pension fund, where the "old" have sold company assets at market value, without the "young" being able to buy them or even ultimately benefit from their positive impact.

"Fair value" has become the reference accounting value for financial assets. IFRS 9 (see 2.A.1.3.) has become the standard rule and has contributed to the

9 *Mark-to-market* rules enable measurement of the value of a company's assets compared with market values.

10 *Book value* measures the value of an asset with respect to its initial cost (adjusted according to depreciation).

11 *"Oser le Long Terme, Refonder l'investissement pour l'Europe de demain" (Dare to think long-term, redesigning investment for tomorrow's Europe)*, long-term investment task force of the Paris stock exchange, presided by Gérard de la Martinière, 2018, and many other references in the trade literature.

volatility of company balance sheets and income statements; it is also likely that it has enhanced market volatility through "procyclicty" phenomena[12].

The financial intermediaries that collect long-term savings, e.g. life insurance companies, have experienced the effects of the Solvency II norm since 2016, which imposes company capital requirements through mark-to-market valuations of assets and liabilities. In spite of the corrections made (notably the PACTE law in France), long-term investment in risky companies that are implementing social or environmental transformations is not sufficiently encouraged. As explained above, the long-term savings of households are thus mostly invested in debt products, and particularly public debts. For banks, the application of IFRS standards and Basel committee standards has increased the company capital requirements, which is good for the solvency of banks, but which, without a highly developed financial market, has hindered the financing of the economy in Europe, because unlike American banks, European banks include business risks in their balance sheets.

Thus, these regulatory standards have led to a reduction in the intermediaries of European financing and transferred the risks of transforming short-term resources into long-term employment to households and companies. The rapidity of these modifications in the financial world has been emphasized by notable exceptions, like that of pension funds, which are not concerned by the Solvency II standards in certain countries, such as the UK, and by the absence of developed financial markets in many European countries.

These norms, which were intended to increase the confidence of households in finance and the financial economy, have resulted in a paradox characterized by increased mistrust among political leaders and a large proportion of the population with regard to the financial industry. It has also improved the credibility of so-called "Rhine model" economic systems, in which the capital of companies is stable and groups of financial and industrial companies guarantee this stability.

12 Procyclicity is the positive correlation between the value of an asset, service or economic indicator and the general state of the economy. Procyclicity can cause very significant price variations, depending on whether the economy is expanding or in recession.

RECOMMENDATION: taking into account the lessons of the 2020 crisis, adapting the prudential standards applicable to financial activities (Solvency II, Basel III) to encourage long-term investment in responsible capitalism.

a) Solvency II, must be reformed to permit more responsible investments in:

- **a.** Large responsible European companies, thus guaranteeing their resilience to enable resistance against international competition;
- **b.** Small and medium-sized companies that produce on a local scale;
- **c.** Long-term investments, by waiving the mark-to-market rule.

b) The Basel Accord resulted in a substantial increase in the capital requirement of European banks, which, unlike American banks, record the majority of the financing of the economy on their balance sheets. In addition, provisioning mechanisms have a procyclical nature. This framework can weigh upon the financing of the economy, even though the ECB relaxed the prudential requirements for company capital during the last period. For many, these agreements are strongly guided by American realities, where the banks are relatively uninvolved in financing the economy and do not record credits on their balance sheet, but sell them on financial markets via securitization. The result in Europe is a constant increase in the company capital of banks and an increase in the cost of credit.

2. The financial markets in a post-crisis situation

A major technological change came about in 2002 on the bond market with the introduction of ETFs (exchange traded funds). Previously, the bond market had high transaction costs and bonds were nowhere near being traded on centralized markets. The bond markets were not liquid and information circulated with difficulty. The 2002 boom in bond ETFs is obvious and these managed assets are expected to represent USD 2,000 billion in 2024[13].

In the European financial system, negative or zero profits for debt instruments exist alongside high profits for shares. However, savings management, whether individual or collective, unregulated or mandatory, is based on a combination of assets of variable risk and profitability. During zero or negative rate periods, bonds do reduce the volatility of return on actions in a portfolio. As institutional portfolios (life insurance, pension funds and retirement funds) are required by regulations and prudential standards to invest primarily in bond assets, overall profitability decreases as these bonds (bearing 3 or 4% coupons), approaching maturity, are replaced with bonds with a nominal return close to zero. The sector of "Euro" guaranteed capital life insurance contracts is in difficulty, in spite of representing more than €1,000 billion in OAT treasury bonds. More generally, and for the same reasons, the fall in the profit rates of pension funds in Germany, in particular, exposes them to difficulties in meeting their commitments in the coming years.

According to the European Banking Authority (EBA), in 2019, European banks were still affected by a stock of €636 billion of bad debt (debts more than ninety days late), i.e. 3% of all loans granted. Overall, the quality of bank balance sheets remains highly heterogeneous within the EU. While this rate remains under 1% in Sweden, it is almost 3% in France, 10% in Italy and Portugal, more than 20% in Cyprus and almost 40% in Greece. The problem remains acute in southern countries, which were more severely affected by the 2007-2008 crisis, and where the legal systems can be very slow to implement the seizure of guaranteed assets in the event of failure to repay a loan.

There are three ways for banks to clean up their balance sheets: get debtors to pay up, enter provisions if they do not expect the loan to be repaid or sell the debt to a third party - generally an investment fund. However, since the Central European Bank (CEB) took on the role of bank police, financial institutions have been under constant pressure to manage these Non Performing Loans (NPLs) as quickly as possible. In spring, the EU adopted new rules to improve the provisioning of NPLs and make them easier to sell. So while bank loans have stagnated, within the framework of risk limitation and increased equity capital

13 Stoxx, *"ETF Inflows Grow, Assets Reach Record"*, January 2020.

requirements, the outstanding amounts of corporate bonds have been multiplied by 2.7 over the past decade.

Fair value

The question of fair value compared with book value is as old as economic analysis[14]. After the Enron crisis in 2000, it was gradually applied to the largest sectors of the American and international economy (banking, real estate, agricultural land). Fair value is determined at three levels:

- Level 1: assets and liability are evaluated at market price (mark-to-market);
- Level 2: if there is no market, fair value is calculated on the basis of a model (mark-to-model) using the observable parameters of a similar asset market;
- Level 3: if no similar market can be observed, fair value is calculated on the basis of non-observable parameters that are specific to the company.

This slow evolution towards increased transparency is taking place in a very specific context of financial capitalism, which generates considerable adverse effects. Fair value is applied at a time when company taxation enables businesses to use unlimited debt financing, not to invest in the company or to compensate for cash flow problems, but to “leverage” their balance sheets and acquire other businesses, or to boost their profitability by buying their own shares. It also occurs in a context of low interest rates and plentiful liquidity, i.e. lendable funds.

This well-known lever effect (debt tax shield) (Modigliani and Miller) is due to financial capitalism. To minimize taxes and improve profitability, a company with access to the financial markets can borrow and use the borrowed funds to buy other companies in its own country or on the financial markets, without endangering its own growth curve. When interest rates drop significantly, this lever effect becomes greater, without tax-reducing liberal economic policy orientations hampering such strategies. This lever effect is the same for all companies, financial or otherwise, the only constraint being access to the bond market.

14 It is defined by Richard Cantillon, William Petty and Adam Smith and, during every major crisis (as in 1929), receives powerful analytical reinforcement.

Tax deduction measures on debt interest payments actually encourage companies to use more debt when tax rates on companies are high. A 2019 study[15] based on a panel of 28 OECD countries, from 1995 to 2015, thus established that company tax is very strongly correlated with company debt but negatively correlated with household debt. This effect is confirmed by a number of publications. A 0.15% increase in the marginal tax rate on companies thus corresponds to a USD 132 billion increase in company debt[16]. This relationship is less true for small and medium-sized enterprises, and is therefore dependent upon the financial constraints suffered by the companies. SMEs have less access to bonds and their capital structure is therefore limited compared with that of large corporations. In other words, large corporations are the main players involved in debt increase when the rate of tax on companies increases.

The combination of mark-to-market, the capacity of large corporations to use debt to exert a lever effect and low interest rates, has led to the domination of the largest groups, massive concentration of production and probably the appearance of speculative bubbles too. Small companies have more constraints and cannot “leverage” their balance sheets, either because they do not have access to the market or because the costs are too high. In practice, the only small companies able to raise debt are start-ups. This financial capitalism, which has failed to slow relocations and production concentration, has thus had societal effects, such as the growth in inequalities, and, all too often in Europe, regional desertification.

The reasons for this are as follows:

- Endless growth of managed assets, due to the lever effect, which results in an inability to stabilize long-term financing, except for the largest structures;
- The inability to develop lasting local structures that are both profitable and protected against takeover by digital franchise networks;
- Depreciation of production assets, which should be accompanied by tax measures on acquisition loan interest;

15 Jinbaek Park and Young Lee, *“Corporate income taxes, corporate debt and household debt”*, International Tax and Public Finance, no.26, 2019.

16 Fleckenstein, Longstaff and Strebulaev, *“Corporate Taxes and Capital Structure: A Long-Term Historical Perspective”*, 2018.

- The inability to improve the social context, accelerate the transformation of the environmental situation and defend the European ownership of European companies in the long term.

It is therefore a matter of urgency that the finance and asset management industry be provided with the means to be efficient in a context of responsible capitalism.

C. Encouraging long-term investment

The project of a responsible European company requires a favorable ecosystem, which, based on European Commission and Member State initiatives, enables European companies to resist non-European majority equity investments and to invest in the climate transition in the long term, while preserving and developing a social model that is specifically European.

There are two possible models that are not necessarily incompatible. The first is that of the rapid development of capital markets in Europe, notably via the implementation of the Capital Markets Union. The second is that of exceptional public funding for the energy transition, i.e. the Green Deal (see 1.E.2.). The combination of the two is the main issue that will determine the economic future for Europe.

1. Capital markets

It is essential that we find long-term financing that is easily accessible to small and medium sized businesses, to encourage their ecological and social transition. European companies suffer from the difficulties of accessing long-term financing on the scale of the challenges they are facing. Incidentally, within their respective sectors of activity, European giants are in competition with Asian and American giants that appear to have unlimited resources and very long-term financing. They are also subject to very strict competition rules, among the strictest in the world, which enabled T. Philippon (2019) to demonstrate greater maturity of the markets in Europe than in the USA (adjustment of prices of services, R&D expenditure, etc.). In one sense, the European system has

encouraged exacerbated competition to increase the purchasing power of households whose income has been stagnant for more than a decade.

The growth potential in Europe is curbed by the absence of capital markets. The exercise proposed by Panagiotis Asimakopoulos and William Bright is original in that it consists in imaging European growth if the capital markets were as developed in every EU country as they are in the five most capitalized countries of Europe. They claim that a very significant rebound in growth would occur, enabling almost 4,000 new companies to be financed with €600 billion.

Furthermore, if the assets of pension funds and insurance companies were invested mostly in company shares, this would generate a financing volume of approximately €16,000 billion in long-term investment for the energy transition and adaptation to sustainable growth. There are two European countries at this stage of development of their capital markets: Sweden and the Netherlands. In Southern and Eastern Europe, the development potential of capital markets is considerable.

The dependence of companies on bank financing and therefore the vulnerability of economies to a bank crisis are well-known. In the USA, bank loans represent just 26% of company borrowing, while bonds represent 74%. In Europe, barely 23% of company borrowing comes from the capital market.

The originality of the model proposed by Panagiotis Asimakopoulos and William Wright[17] is that it tackles the problem from the opposite direction. It considers the possible effects, in terms of job and company creation, of rapid and proactive development of capital markets in Europe. We have seen that needs are considerable even with the same system, and the perspective of an energy transition makes these needs enormous. Two attitudes are therefore possible:

I. Defining public financing by debt to cover these new needs;
II. Using household savings to develop efficient capital markets to enable this new boom.

17 Panagiotis Asimakopoulos and William Wright, *"Unlocking the Growth Potential in European Capital Markets"*, June 2019.

Larger capital markets ares not an objective *per* se but they enable diversification of company financing sources, promotion of innovation, development of longer-term investments and easing of the constraints on pension financing.

The logic of a financial system is that of mediation between the interests of its debtors and those of its creditors. How, in a context of stagnation and low or negative real interest rates, can this mediation be achieved and under what normative and specifically European framework could long-term investments be permitted?

Four major objectives must enable European finance to be reorganized with a view to responsible finance:

1. Generate more long-term savings and investment instruments, adapted in particular to the challenges of the energy transition;
2. Develop capital markets massively;
3. Develop greater fluidity between the European financial stock markets;
4. Develop international debt financing instruments for investments in responsible capitalism to consolidate the role of the Euro as an international reserve currency.

These four objectives are at the origin of the Capital Markets Union (CMU) project. The CMU project was first proposed by the Juncker Commission in 2014 but never implemented. It aimed:

1. To harmonize prospectuses and simplify reporting;
2. To eliminate regulatory barriers, notably those restricting the access of SMEs to financing;
3. To reduce tax distortions.

Its failure was mainly due to the impossibility of harmonizing tax rules and bankruptcy laws in the different countries. This dossier must be re-examined as a matter of urgency, this time including the possibility of overcoming or removing national protective systems over capital markets.

The symptoms are well-known: capital circulates with difficulty in Europe, although the unequal distribution of capital is not the same in all European countries, and capital tends to be hogged by the sovereign debts of the largest Member States. It is not enough to resist the competitive pressures and takeover ambitions of North American and Asian companies. The fragility of the capital market is due to two sets of causes: the importance of pay-as-you-go social protection and the existence of a range of regulatory barriers that can be different from one country to another. Thus, the risk for investors is different depending on the country and investment in SMEs is difficult and expensive.
The problem is not the skills of European companies, nor their innovation and development capacities; it is mostly due to their difficulties in defending themselves and maintaining market share in other countries. From the companies' point of view, the fact that it is easier to invest in Asia than on the banks of the Danube corresponds to a loss of Europe's very substance. It is also a loss of value and opportunities: the opportunity of imagining, building and enjoying together the benefits of economic activity on a European scale.

A new initiative to make the European Securities and Markets Authority (ESMA) an efficient regulator of the financial markets throughout Europe would enable significant progress: simplification of the procedures to access financing and the emergence of financial products suited to SMEs. The rules of public share offerings, company governance and mobility for these companies must be adapted to the objective of achieving true integration of the financing market. This is essential to restore convergence paths within Europe, and therefore growth potential, but it is not sufficient.

To sum up, the new economic model for Europe must be based on European companies, which are currently facing a number of challenges and weaknesses:

- Fragility of their capital base;
- Difficulty of competing with Asian and American giants, notably in the cutting-edge technologies sector;
- Low level of domestic European demand due to the lasting absence of pay increases;
- Slow growth of European exports in a context of overall economic slowdown;
- Urgency of the low-carbon transition.

2. Flat tax and bankruptcy law

We believe it is urgent to create a single flat tax for capital income in Europe with specific conditions for pension savings income. After Brexit, the difficulty might not actually be as large as it first appears, because this already exists in several European countries (France, Estonia, Latvia, Lithuania, Romania, Hungary, Czech Republic) and because Europe has already achieved a certain fiscal harmony (European VAT).

Defining harmonized bankruptcy laws applicable throughout the EU is another priority to protect European investors. Protecting responsible investors must become a priority of European policy, in the same way as what has been accomplished to harmonize consumer protection. The harmonization of bankruptcy law therefore appears to be a prerequisite condition to the emergence of a generalized European vehicle and is more urgent than it may appear because of the large number of European companies in need of major restructuring projects. These “zombie” companies (Andrews, Petroulakis 2019) are a cause of bank vulnerability and raise the cost of financing for new companies. The legacy of insolvent companies that enjoy complicated and slow-moving bankruptcy conditions also tends to slow growth, notably due to poor allocation of capital. This project is all the more urgent in the context of economic recovery following the Covid-19 health crisis, which caused long periods of lockdown in many Members States (Belgium, France, Italy, etc.), bringing their economies to a halt. The bankruptcy law harmonization project is often described as impossible. But are we not in an era when Europe has achieved what was once considered not only impossible but intangible?

The EU must also ensure that the 2019/1023 directive on restructuring and insolvency is transposed as uniformly as possible in each Member State, ensuring that companies can obtain refinancing under equivalent conditions and as inexpensively as possible, to avoid insolvency situations and the subsequent job losses. This directive defines a framework for "preventive" restructuring to be applied before a debtor is formally declared insolvent.

The issue of insolvency is an obstacle to business expansion and cross-border investment. Different and somewhat opaque procedures in the different Member States discourage investment. Better harmonization of insolvency laws was necessary to ensure smooth operation of the single market and the creation of a Capital Markets Union. More convergence of insolvency and restructuring procedures should help to guarantee more legal security for cross-border investors and would encourage restructuring in good time when difficulties arise.

The economic objective of this directive is three-fold: to ensure equivalent, low cost financing conditions for companies, primarily SMEs, to reduce the number of non-performing loans on the balance sheets of European banks and to improve the Capital Markets Union.

The issues of climate transition and CSR are therefore dependent on the possibility of preserving the competitivity and value-creation capacities of European companies, and the ability to restore full employment and inclusive economy objectives. Investments for the climate transition will only be made if there is a growing, solvent demand in Europe.

RECOMMENDATION: developing the Capital Markets Union for investment in responsible companies at European level and, within this framework, harmonizing the tax rules applicable to the various investment instruments in Europe to determine a European flat tax on financial assets and harmonized bankruptcy laws as quickly as possible.
Transposing the “Restructuring and Insolvency” directive as uniformly as possible in each of the Member States.

3. Private equity

After the 2007-2008 crisis, efforts to support the company capital of banks resulted in difficulties in financing the economy. European financial markets remain fragmented and obey standards and regulations that are not the same.

The laws concerning bankruptcy and insolvencies different from one country to the next and further complicate matters in terms of risk-taking for investors. We can learn a lot from the example of long-term financing funds for unquoted companies. The market is dynamic, representing €120 billion in assets, and is concentrated in the UK, which represents a larger volume under management than France and Germany put together.

The development of an ambitious European vehicle based on social and environmental ratings, favoring long-term investments and unquoted companies, is an essential objective for savers, companies and asset managers.

In this sense, the European long-term investment funds (ELTIF)[18] have a lot to offer, because they can be used by SMEs and make it easier to obtain a loan without issuing a bond. Furthermore, for savers, the ELTIF funds offer a higher level of profitability than public bonds and quoted companies, because the value of the company is quite different from its quoted price.

However, the 2000 crisis, the 2007-2008 crisis and the recent WeWork adventure[19] show that private equity is not a simple, risk free solution either, and that it can involve sudden corrections amplified by risk analysis.

Another equally important concern is the need to recreate short investment circuits, which remains a priority for all European countries. Europe is characterized by desert regions in terms of production and services and most financial assets being owned by pensioners (although these assets are highly concentrated) but invested in risk-free State bonds. Creating vehicles to enable these pensioners to invest some of their savings in local services or production via private equity could be one of the foundations of the responsible capitalism of aging countries, although the model must be defined in terms of profitability and security. This type of vehicle would offer a financial return, probably slightly higher than that of State bonds, and a qualitative return in terms of well-being.

18 The ELTIF funds were introduced by European regulation 2015/760, which became applicable on December 9, 2015.
19 Les Echos, *"WeWork : récit d'un fiasco à Wall Street"* (WeWork: the tale of a Wall Street fiasco), September 28, 2018.

RECOMMENDATION: creating private equity funds allowing for local investment and that direct the financial savings of one region to the companies of this same region so as to enable the development of local employment.

4. Employee profit-sharing and investment incentive schemes

Having employees invest in the capital of European companies is an essential element of capital stability and its resilience to foreign investors. It is also coherent with the definition of long-term objectives for company strategy. Incidentally, it can also be a very effective tool to formalize respect of the purpose of responsible companies.

The situation is vastly different throughout Europe, with diverging philosophies on employee investment. Some countries believe that such schemes are part of the pay negotiation (Italy, Spain) and have not set up any specific tax incentives; some have highly developed regulatory frameworks to encourage employees to invest in the shares of their company (Belgium, UK); and others, like France and Germany, have developed legislative frameworks that are different than those of the Anglo-Saxon model, being less oriented towards the investment in shares of the employer company and more oriented towards helping the employee to invest in financial assets.

Thus, employee profit-sharing schemes are mandatory in France for companies with more than 50 employees that made a profit the previous year. The amount of the profit-sharing bonuses paid to employees depends on the annual results of the company. A maximum amount per year per employee is defined by law. Investment incentive schemes are optional and taxable, unless the bonus is paid into a company saving plan, where it remains blocked for five years. Thus, a large number of companies have set up both investment incentive schemes and company savings plans.

RECOMMENDATION: increasing employee shareholding, notably by harmonizing the rules concerning profit-sharing and investment incentive schemes[20].

The European Commission has implemented a proactive policy to encourage the development of employee investment in company capital. It is important to transform these intentions into a practical framework to enable generalization of the investment in responsible European companies, for example via the **European Savings Plan for Company Savings, which should be created.**

This recommendation could be put into perspective with a debate on the **advantages of forms of remuneration for company governance and shareholders that are offset in time to encourage managers and their shareholders to consider long-term strategies, compatible with long-term societal and environmental objectives.** For examples, bonuses or additional bonuses to be paid 5-10 years after decisions, provided these decision prove conform to social and environmental objectives, could change the strategic orientations of companies and enable them to respect these long-term challenges.

Thus, in the responsible European company of tomorrow, the employees would participate significantly in the share capital, thus associating them with the objectives determined by the governance, and the governance would be paid longer-term bonuses, thereby guaranteeing compliance with the strategies developed with respect to CSR objectives.

20 As we already proposed in our January 2018 report, *"ETI : taille intermédiaire, gros potentiel"*, (ETIs: intermediate size enterprises with huge potential).

D. Responsible capitalism and crisis management

Responsible capitalism must be armed for crisis management. In the wake of this recent crisis, a responsible company is therefore one that promotes the health of its employees and clients. This has several consequences:

- A responsible company must have sufficient cash flow or insurance to be able to pay the wages of its employees during quarantine periods lasting between 3 weeks and 3 months, and be particularly careful to protect its employees' workstations, – which means redefining the priorities of risk management in companies;
- A responsible company must also be able to manage its stocks to meet demand while production is interrupted for periods lasting between two weeks and one month.

Thus, we propose to consider **including among the criteria of a responsible European company, stock and cash flow management, which depend on the degree of dependence of supply chains.** The debate on the relocation of production chains will perhaps become more realistic if it is counterbalanced by efforts to save money on stock management.

E. Europe's investment needs

The low level of private investment in Europe is a major problem, causing low productivity, low growth and undermining competitiveness. Between 2008 and 2015, gross investment in the Euro zone dropped by 15% and the rate of investment fell by four points. In the USA, investment has returned to the same level as before the 2007-2008 crisis.

1. Structural needs that have intensified since the 2007-2008 crisis

Infrastructure

The infrastructures of the Euro zone are in need of particular attention. Since the 2007-2008 crisis, infrastructure investments have dropped from 3% to

2.5% of GDP. The ratio oscillated between 3 and 3.5% of GDP in 1990-2000, and is currently stable at 2.5%. The countries are affected differently: while needs are acute in the Southern European countries (Spain, Italy, Portugal) that implemented austerity measures to reduce their debt, France, Ireland and Germany are in no better position[21]. One study (DIW, 2017)[22] recently reported that almost 20% of Germany's highways and 41% of its main roads were in need of repair. Almost one third of its railways bridges had exceeded their "expiry dates". According to the institute, since 1999, Germany has accumulated an investment shortfall of almost €1,000 billion.

Quality infrastructures are important for two reasons: they prevent the isolation of remote or rural areas and facilitate the digital transition. Infrastructure investments are also long-term projects that create jobs. Finally, infrastructures benefit from technological progress and are essential to the development of an environmental-friendly economy. An ambitious recovery plan based on infrastructures should be a priority for the European economic policy. However, the slow pace of project implementation is related to the political and local acceptance of these projects. A green infrastructure project is essential, constituting a competitive advantage for tomorrow.

Energy

The EU's 2030 energy and climate framework provides for a 40% reduction in greenhouse gas emissions by 2030 compared with 1990, an improvement in energy efficiency of at least 27% and a proportion of 32% renewable energy in overall EU energy consumption, an objective that is binding at the European level[23].

21 *"Oser le Long Terme, Refonder l'investissement pour l'Europe de demain"* (Dare to think long-term, redesigning investment for tomorrow's Europe), long-term investment task force of the Paris stock market presided by Gérard de la Martinière, 2018, 2016 and Le Monde, "Apprendre à financer le futur" (Learning to finance the future), Patrick Artus, Etienne Klein and Jean-Hervé Lorenzi, April 20, 2020.

22 DIW, *"Verkehr in Zahlen 2017/18"*, 2017, (S. Radke, Ed.), Berlin: BMVI.

23 Institut Montaigne, *"Pour réussir la transition énergétique"* (Making a success of the energy transition), June 2019.

Renewable energy in most European countries accounts for between 10 and 20%, and the target will not be reached without cross-border investments in Europe. The good news is that some countries have succeeded; Sweden already has 50% renewable energy in its energy mix. France and Germany have about 16%, while Poland has 11%. Although the Scandinavian countries are the clear leaders, the efforts of Portugal (30%) and Romania (24%) also deserve recognition[24].

Transport

The transport sector represents 24% of all greenhouse gas emissions worldwide. Almost 75% of these emissions are caused by road transport[25]. The road transport transformation is in progress, with sales of electric and hybrid cars increasing, the development of car-sharing and car-pooling schemes, etc. However, to meet the commitments to reduce global greenhouse gas emissions by 40% between 1990 and 2030, the development of new infrastructures must also enable modal transfer from car to clean transport solutions. Adopting the same normative principles for traffic regulation throughout Europe also appears to be essential[26].

Incidentally, sea transport, the cornerstone of world trade, is also a major source of pollution, causing more than 3% of global greenhouse gas emissions[27], a rate that could be multiplied by four by 2050. Developing green port infrastructures and clean transport solutions in Europe today offers three advantages: less pollution in the port cities of Europe, more economical transport (due to lower carbon levels) for the future and control of worldwide trade flows.

24 Eurostat, *"Renewable energy in the EU in 2018"*, January 23, 2020.

25 French ministry for the ecological transition and solidarity, *"Datalab, chiffres clés du climat"* (Datalab, key climate figures), 2019.

26 Institut Montaigne, *"What role for cars in tomorrow's world?"*, June 2017.

27 European Parliament, *"Emissions from planes and ships: facts and figures"*, 2019.

◗ Health, social, education

The decline in investments in the health sector has brought about a hospital crisis affecting all European countries, and a domination of non-European laboratories. Furthermore, the aging of the population is causing growing needs in the health care sector. Health plans on the European scale could be designed and accepted by the population, and European financing plans for vulnerable populations would bring stability to the social context, improving on what exists today.

Our experience of the Covid-19 epidemic has shown that the German model, where the privatization of certain hospitals is counterbalanced by local health policy management with health ministries in each Land and more attention overall to public health issues, obtained better results than centralized systems dependent on administrative management models. Better cohesion between the health and medico-social sectors also appears to improve overall efficiency significantly.

The Prodi Sautter working group (Fransen 2018) assessed the financing effort for social infrastructures in the fields of education, health and social housing, and compared it with the financing needs of 2030. The investment effort required is around €1,500 billion for the 2018-2030 period. The gap between investments and needs thus represents €15 billion per year for education, €70 billion per year for health and dependency, and €57 billion per year for social housing.

Indeed, after the 2007-2008 crisis, public investment fell considerably in a context of public debt and budgetary adjustment. Finally, the fact that the most indebted economies are those with the greatest needs in terms of infrastructure investments, indicates that this is a consequence of the reduction in public budgets. This observation also reveals that the problems of education, health and housing are not only related to the amounts of public investment available, and that we should probably re-examine the organization and administrative management of these public policies and attract long-term private investments to these sectors.

RECOMMENDATION: to finance responsible growth in Europe, we must allocate European financial resources to long-term investments:

- **Used to meet the needs for responsible infrastructure and to reduce inequalities between European countries;**
- **Used for investments enabling the ecological transition;**
- **That encourage private investment in responsible infrastructures, which are drivers of growth and local development;**
- **Accomplished through investment plans for strategic European infrastructures with concession schemes adapted to the requirements of responsible capitalism.**

2. A health crisis with social, economic and environmental consequences

◗ Health infrastructures and supply chain management in light of the Covid-19 epidemic

The Covid-19 crisis is a global crisis. It affects all countries, calling into questions the mechanisms of production, consumption, social protection and finance. It will therefore very quickly offer an opportunity to re-examine the economic and financial model that has dominated since the early 1980s. There are many risks involved:

- For companies, the risk of bankruptcy or the disappearance of certain sources of financing;
- For households, the risk of a decline in income and the disappearance of financial intermediation;
- The risk of increased state control, with a high level of company dependency on public policies, which must respond, in the short-term, to the radicalization of populist patronage.

It is therefore urgent to define a European model for the responsible company and the window of opportunity for defending this option is very limited. The health crisis will result in a recession that is likely to be severe and highly atypical: under normal conditions, a moderately severe flu epidemic causes a global decline in GDP of around 0.7%[28]. However, it is interesting to observe that for a moderate epidemic, 40% of the costs of the epidemic are due to a decline in income; this decline only accounts for 12% of costs in a severe epidemic, for which the intrinsic costs of mortality are dominant[29].

Thus, most costs concern the decline in business income, due to production interruptions and falling consumption. This is a unique, severe crisis, but the economies that are resilient enough (little or no loss in terms of human capital and no infrastructure losses) and therefore have the capacities, although not necessarily suitable financing, will be able to bounce back relatively quickly.

Rapid implementation and magnitude of the recovery plans are therefore obvious conditions for accelerating the post-crisis process. This process will depend on Europe's financial solidarity, which itself will depend on the asset management objectives in the various institutions of the different countries. Thus, countries whose populations have prepared their retirement by capitalizing on bonds will not have the same interests as those that capitalized on shares.

In the post-crisis period, companies will have to redefine production and financing plans. They will also have to reconstitute their markets and win back their customers. This will involve restoring the faith of customers, employees and savers. To achieve this, they will need suitable financing systems that protect savers against sudden variations in the value of their financial assets. The severity of the recession in the short term will, in fact, be aggravated by the financial situation that was already fragile (but optimistic) before the crisis, characterized by high levels of public and private debt, an abundance of liquidity, inflation of financial assets and very low interest rates.

We must build a new financial system in Europe that is more integrated and more attentive to the needs of SMEs in particular. Exceptional measures to support

28 World Bank, *"Evaluating the Economic Consequences of Avian Influenza"*, Andrew Burns, Dominique van der Mensbrugghe, Hans Timmer, 2006.
29 Victoria Y. Fan, Dean T. Jamison, Lawrence H. Summers, *"The Inclusive Cost of Pandemic Influenza Risk"*, NBER, 2016.

the worst affected strategic sectors (energy, car industry, financial services, etc.) will probably also be necessary, in line with the environmental objectives of the European Union.

This crisis is also a real crisis, i.e. the production modes will have to change rapidly to achieve greater European integration and reconsider the principles of just-in-time management. Consumption modes could also be affected, with more attention being given to local production, less tourism, less transport, more people working from home, etc.

The magnitude of the crisis in each country is also a consequence of the efficiency of the social protection systems in place: the quality and rapidity of public health decisions will have enabled countries such as South Korea[30] and Germany to avoid the consequences of very long lockdown measures. The number of intensive care beds per inhabitant and the rapidity of treatment provision is an obvious factor associated with the pandemic's different mortality rates. However, huge inequalities exist in the health sector; Europe suffers from serious inadequacies in terms of health and the efficiency of its health care systems.

The European recovery plan

The sheer scale of the consequences of the lack of preparation in the health sector is an indicator of one of Europe's persistent problems, delayed infrastructure spending and the end of the convergence of European economies since the 2007-2008 crisis. A recovery plan for European infrastructure spending is therefore imperative after the crisis and will redefine the objectives of the Green Deal and the relevant taxonomies.

In the context of the crisis, the European recovery plan of July 2020 proposes notably the creation of a €750 billion "recovery fund" for the sectors and

30 Institut Montaigne, *"Coronavirus : l'Asie orientale face à la pandémie - Corée du Sud : dépistages, investigations ciblées et la question de la vie privée"* (Coronavirus: East Asia and the pandemic - South Korea: screening, targeted investigations and the question of privacy), Mathieu Duchâtel, François Godement, Fiona Trichard and Viviana Zhu, March 26, 2020.

regions of the EU most affected by the health crisis and its repercussions. In this recovery plan, the European Commission distinguishes between loans of up to €360 billion and €390 billion in grants. The criteria for allocating these funds are not yet precisely known, but it has already been agreed that these criteria will be based on growth, job creation and social resilience of the Member States.

The Green Deal was Europe's new growth ambition, led by Ursula von der Leyen, from 1 December 2019. This project aimed to strengthen, standardize and boost the EU's policies to combat global warming by promoting a common European framework. Today, the recovery plan sets a criterion of 30% of the investments to be devoted to the energy transition in order to achieve carbon neutrality by 2050. The EU believes that only massive public investment in addition to continued private sector efforts can make a difference and provide a new business environment conducive to low carbon solutions.

As a reminder, the European Commission had identified seven areas for action: energy, industry, construction and renovation, mobility, biodiversity, agriculture and food, and pollution. Specific action plans for each sector are currently being drawn up. In addition to these seven areas, the much-anticipated "carbon border adjustment mechanism" is due to be launched in 2021; this mechanism, to be established sector by sector in compliance with World Trade Organization (WTO) regulations, aims to protect European companies that respect environmental standards. In practice, application of an agreement would be suspended if the other party fails to respect its climate obligations. The emission quota trade system will also be imposed in new sectors, notably air and sea transport, as well as the construction industry.

Nonetheless, while the Green Deal supported the ecological transformation of the economy, it did nothing to guarantee social transformation. After the crisis, the recovery plan is more focused on social objectives and in particular on employment. However, a model of responsible capitalism is one in which long-term objectives are guaranteed by private investment and transformation objectives are driven by public debt, subscribed by third country savers seeking long-term stability.

The "S" of CSR poses two problems here. The first is that the social issue is not the same in all European countries. Each country has its own economic and social history and the understanding of social and societal challenges is quite different. The conditions of social protection are therefore highly disparate, in terms of both universalist or contractualist financing modes and their defined objectives. It is hard to get the countries to agree on the fundamental social objectives and common conditions to be implemented. Perhaps it would be possible to agree on objectives related to a joint reality, i.e. the aging of our populations. From a societal point of view, this imposes inter-generational harmony, which means being more careful not to exclude the younger generations and ensuring their access to employment, housing and training. At the same time, aging demands that more attention be paid to the older generation, notably to ensure their access to the necessary medical and social services. These two objectives could perhaps characterize a definition of societal objectives shared by all European countries, and coherent with the challenges of responsible capitalism. Incidentally, one joint horizon might be the conditions of social acceptance of the environmental transition.

The other difficulty in defining the "S" is that while environmental measures can be decided and are measurable, it is much more difficult to understand the long-term social effects of a company strategy or investment decision. And the realization that the decisions taken contradict the social objectives often comes too late.

RECOMMENDATION: defining the terms of a social taxonomy to complement the ecological taxonomy, taking into account health and social concerns.

II

INFORMATION

Information is at the core of capitalism. It is an integral part of the operating principle of markets and companies financing.

Today, information is produced at two levels: 1) that of the company, which is subject to strict reporting obligations; 2) that of the investors, which have their own business knowledge and assessment instruments. For the promotion of responsible capitalism, these two levels of information are now split into "financial" and "extra-financial" elements. Companies are thus required to produce accounting reports in compliance with very strict rules, and extra-financial reports, which are becoming increasingly regulated every year. As for investors, alongside the tools to evaluate the financial aspects of businesses, they are developing extra-financial assessment techniques that are gaining importance in the resource allocation decision process.

Specifically, extra-financial reporting as a means of extra-financial evaluation, describes and measures what is commonly called the company's "responsibility", what enables the company to be qualified as "responsible". This must not obscure the company's responsibility with respect to its shareholders nor lead us to forget this aspect of its mission. Companies do have a financial responsibility: it is measured by profitability. Extra-financial responsibility, on the other hand, describes the method, processes and behavior that enable the company to make profit: its ethics. This begins with the purpose of the company: is the company seeking profitability via prohibited or dangerous means, purely to maximize its short-term profit? It also encompasses compliance with fundamental standards (concerning child labor, corruption, tax evasion, etc.), i.e. the laws and values that determine the tolerance levels and ambitions of the societies in which the companies operate.

The progression in the responsibilization of capitalism can be measured by the importance given to extra-financial aspects in both company operation and evaluation. At present, national and European companies are required to publish an extra-financial report, which is expected to become the topic of a European standard. Investors tend to include extra-financial aspects in all their management decisions. National and European regulators are actively encouraging this, while seeking to define a framework for the movement.

These issues of accounting, financial and extra-financial information may appear to be of secondary importance compared with what the company actually produces, its profits, the number of jobs, and how it behaves, but, in fact, they are decisive. They are the key to how capitalism functions and the principles of trade and connections between what is called the "real economy" and the financial world that finances this real economy, in the same way as oxygen is necessary for the lungs to work.

The production of accounting, financial and extra-financial information, a strategic domain, must contend with one fundamental difficulty that is particularly relevant in accounting: it must translate a tangible and intangible reality into monetary value, a price expressed in currency. This implies conventions, which also serve a dual purpose: they must provide the most accurate representation possible of reality and they must be accepted by all those involved as the expression of the company's "true" value. They must be reliable, being designed to instill confidence. These conventions therefore have a representation function and a communication function. They cannot be defined solely by the parties involved. The existence of markets implies the normalization of these conventions by a regulator trusted by the parties involved and/or public authorities able to impose them.

Accounting standards, based on conventions, cannot exclude a certain arbitrariness in the way in which an accountant choses to express the value of a specific asset. In the past, accounting standardization in Europe opposed the fundamentals of two main philosophies: historical cost and market value, the first being based on the cost of acquisition and how this value evolves over time, the second based on the value the asset would generate if traded at the time of *the valuation. The two evaluations will have quite different results in the case of a stock market portfolio during a financial crisis, for example.*

The principal debates over accounting standardization thus concern convention systems with a totally different vision of value. The same is true, although in a different manner, for extra-financial reporting and evaluation. For example, how should a company's CO2 emissions be measured? How can we determine whether or not its trajectory complies with the Paris Agreement? This will depend on whether we consider only the emissions of the company itself or also include those of its sub-contractors or even its clients during use of the product. These conventions also concern what should be observed (and how) on a map of the company's activity from a responsibility point of view, as well as how to produce an assessment, generally in the form of a score (not a price), to enable comparison of different companies. In this area, having allowed the players to define their own evaluation criteria, the regulator is becoming increasingly active to produce standards and introduce market conventions to enable the players to reach agreement. Information is therefore a fundamental element of the framework of responsible capitalism.

How do things stand in Europe? The situation can be described as follows: loss of control and contradiction.

- *Loss of control. This applies to both the financial and extra-financial aspects of information. As illustrated by the extraordinary story of the imposition of the International financial reporting standards (IFRS standards) in the USA and the fair value ideology within the European Union (EU), which has led Europeans to accept accounting standards that have nothing in common with the social market economy philosophy, in a vain hope to gain access to the American financial markets. It is also true that extra-financial ratings are in the hands of American agencies, whose power continues to grow. The evaluations of the parties involved in responsible investment are thus based on data that they provide themselves, but do not necessarily express their values. If we are to create responsible European capitalism, there is one essential thing to be done: Take Back Control, live up to our values.*
- *Contradiction. This is due to the fact that while the European Commission is promoting accounting standards that encourage short-term assessments, it is also, at the same time, trying to develop a "responsible" vision of company operation and investment, which is necessarily based on long-term evaluation. The Commission's attitude thus causes tension, even opposition, between the accounting vision and the extra-financial vision. The situation has become impossible, as the Commission acknowledged in its 2018 action plan on sustainable finance. Specifically, resolving this contradiction can and must be turned into an opportunity for Europeans to regain control over the way in which companies, and particularly responsible companies, are evaluated.*

A. Accounting information and extra-financial reporting

The company produces financial and extra-financial information, which is then analyzed and processed by analysts, rating agencies and other stakeholders. This "primary" information is therefore fundamental.

The **financial information** is obtained based on international accounting standards established by an international organization and which are more short-term than long-term oriented, thus weakening the companies committed to a responsible model and hindering their access to financing.

The **extra-financial information** is obtained based on criteria that are also determined by international, generally Anglo-Saxon, organizations, whose main purpose is to protect the company. These criteria do not fulfill the expectations of society, which calls on companies to preserve and even enrich their social, societal or environmental ecosystems.

Above and beyond the necessary reform of accounting standards, Europe must define its own extra-financial criteria to support responsible capitalism so as to fulfill the expectations of our societies. Europe must do more than just protect its companies from ESG risks and must ensure that the companies protect society and its environment, while also generating profit.

1. Accounting information must reflect the reality of the responsible company

IThere would be no point in allowing capital to circulate freely within the EU if there was no common accounting framework.

The European Commission has been campaigning for many years to harmonize accounting standards. Two directives were adopted in the 1980s[31], but they soon proved ineffective in terms of helping companies to develop internationally. The companies, as well as the financial markets from which they seek financing, found that the accounting reference systems applicable in Europe did not provide sufficient financial information. Furthermore, the Securities and Exchange Commission (SEC) required that European groups wanting to raise capital on US financial markets had to present their accounts according to American standards. Many people supported the idea that the EU, which had failed to agree on a common accounting system, should comply with the American standards.

While nothing prevented the EU from adopting the USA's GAAP rules (the American accounting rules), such a decision would have raised genuine concerns in terms of sovereignty, with serious consequences for European businesses. Adopting their rules would be paramount to accepting the control of American standards over the management of European businesses, relinquishing control into the hands of an accounting standards body that may change its standards without considering their interests, and a foreign market authority with sole competence over the interpretation and verification of the application of these standards.

The European Commission therefore published a guide[32] in 1995, which, for the first time, envisaged the possibility of quoted European companies applying the international accounting standards defined by the board of International

31 The Fourth Directive 78/660/EEC, of July 25, 1978, harmonized the national provisions on the structure and content of annual accounting statements and management reports, valuation methods and the publication of these documents. The Seventh Directive 83/349/EEC, of June 13, 1983, did the same for the conditions applicable to the drawing up of consolidated accounts.

32 European Commission, *"Accounting harmonisation: a new strategy vis-à-vis international harmonisation"*, 1995.

Accounting Standards (IAS), as well as European directives. The aim of the Commission was to reassure the International Organization of Securities Commission (IOSCO), which had expressed concerns over the difficulties of having different accounting standards for international investors. It decided to encourage the International Accounting Standards Board (IASB) to move towards a full set of high quality, harmonized accounting standards. In 1999, this strategy was included in the EU's action plan on financial services.

The IASB was reformed and a new board was constituted in 2001. The existing IAS standards were integrated as the starting point for the new reference system, pending possible revision. A new name, International Financial Reporting Standards (IFRS), was adopted. The IOSCO and the Commission, wanting to adopt a world-recognized reference system, thus approached the American authorities, including the SEC, which believed that convergence of America's Financial Accounting Standards (FAS) and the IFRS standards was necessary. In 2002, the two organizations signed a Convergence Agreement setting out the conditions for cooperation and a work program was published in 2006.

In November 2007, following a vast consultation project, the SEC authorized foreign issuers to publish the accounting information documents required by its regulations in compliance with IFRS standards, without having to present at the same time either a reconciliation with data processed according to US GAAP, or US GAAP compliant accounts.

From 2007 to 2015, cooperation efforts continued between the two boards, IASB and FASB, resulting in a certain convergence. However, in spite of the progress achieved and pressure from regulators, the USA did not come any closer to adopting IFRS standards. The days of convergence of accounting standards were over, and would be for many years.

1. Europe abandons accounting sovereignty

Being unable to agree on a European accounting reference system and under the pressure of fast-accelerating globalization, the EU relies on IFRS accounting standards, drafted by the IASB, a private body over which it has no control.

On July 19, 2002, the European Parliament adopted Regulation (EC) no. 1606/2002 and IFRS standards to facilitate operation of the capital market, to protect investors, to preserve confidence in the financial markets and to help *"Community companies to compete on an equal footing for financial resources available in the Community capital markets, as well as in world capital markets."*

Europe thus delegated its accounting sovereignty to a private international organization amidst widespread indifference, probably because it appeared to be a distant and uncertain prospect concerning a complex, technical subject whose importance was truly understood by too few people.

The accounting regulation also defines the framework for adopting IFRS standards within the EU, by creating EFRAG[33] and ARC[34]. **EFRAG** is responsible, on behalf of the Commission, for monitoring the drafting of accounting standards by the IASB and for intervening to defend European interests. It reviews the standards proposed by the IASB and their application in Europe based on a technical analysis and consultation of all concerned parties. **ARC,** presided by the European Commission, is composed of representatives of the Member States. It acts after reading EFRAG's technical review and only rules on the compliance of the standard with European legislation. An accounting standard drawn up by IASB can only be adopted by the EU after being reviewed by EFRAG, which recommends either adoption or rejection, then by ARC, which issues an opinion on the decision proposed by EFRAG. The European Commission then decides whether or not to integrate the standard into European law.

By opting for ex post approval, once the IFRS standard has been approved and published by IASB, the EU deprives itself of any possibility of amendment, thus refusing to "Europeanize" an accounting reference system that is global, according to the IASB objectives. EFRAG, which is supposed to defend European interests during the drafting phase of standards by the IASB, has never done so.

33 European Financial Report Advisory Group.
34 Accounting Regulatory Committee.

Similarly, the EU refrains from interpreting IFRS standards. This position was made clear in the European Commission's comments on certain articles of Regulation No. 1606/2002/EC, published in November 2003: *"in a principles-based system such as IASs there will always exist transactions or arrangements that are not covered by explicit rules. In such circumstances, IASs specifically require management to use its judgment to determine the most appropriate accounting treatment. [...] National law may not, by specifying particular treatments, restrict or hinder this requirement to apply judgment in the manner envisaged. As the IAS Regulation is directly applicable, Member States will ensure that they do not seek to apply to the company any additional elements of national law that are contrary to, conflict with or restrict a company's compliance with adopted IASs, further to the IAS Regulation*".

IFRS standards must therefore be applied as they stand in the EU, which may not propose amendments or modification. Europe can simply decide to reject a standard by refusing to adopt it. In the event of disagreement between the IASB and the EU, fastidious efforts to find a compromise to satisfy both parties must be made.

2. From accounting standards to financial reporting

IASB has thus imposed its model for investors. The accounting standards have become the standards of financial reporting, reflecting the consecration of the company's financial value over its accounting value. For IASB, *"the objective of general financial reporting is to provide financial information about the reporting entity, which is useful to existing and potential investors, lenders and other creditors so that they can make decisions on the allocation of resources to the entity. These are decisions about buying, selling or holding equity or debt instruments, providing or settling loans and other forms of credit."* IASB thus imposes upon Europe its view of the corporate reality according to its own philosophy.

IFRS standards insist on the characteristics of the information for decision-makers through compliance with four criteria: understandability, relevance, reliability and comparability, while French accounting standards focus on business continuity, sincerity and regularity. Other apparently similar characteristics are, in fact, quite different. This is the case of **prudence,** a principle that is limited, according to French accounting standards, to the inclusion of latent losses in the accounts, whereas for IFRS, the principle imposes a certain degree of precaution when making the judgments required to produce estimates in uncertain conditions, so that assets and income are not over-valued and debts and charges are not under-valued.

IASB has also introduced the **principle of substance over form:** economic substance takes precedence over the legal form of the elements of the balance sheet, which has considerable consequences on account presentation.

3. Fair value, the cardinal principle of IFRS standards

Fair value first appeared in 1995 with the publication of the IAS 32 norm, which defined fair value as *"the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction"*. Since then, almost all international accounting standards have used the concept of fair value.

On May 12, 2011, IASB published **IFRS 13, "Fair value measurement**", setting a unique framework for the determination of fair value for financial reporting. This became the value of reference in international accounting approaches. The European Commission included it in the Accounting Regulation, amended accordingly on December 11, 2012[35].

In theory, fair value can be determined according to market price or the discounted cash flow calculation. In practice, the first method is most used, and market value has become the accounting measurement of reference.

35 According to EU regulation No. 1255/2012: *"Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same-to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability)."*

On November 22, 2016, the Commission adopted **IFRS 9** – which replaced IAS 39 – and included it in its Accounting Regulation in order *"to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows."* This norm is applicable to European companies proposing a public offering since January 1, 2018.
Incidentally, **IFRS 17** will replace the current IFRS 4 norm on insurance contracts for accounting periods starting on January 1, 2023. It will make significant modifications to the rules for valuing insurance liabilities and will demand detailed information on the risks and assumptions underlying the technical provisions.

Applied to company capital instruments, notably shares, **IFRS 9 and 13** result in either volatility that does not reflect the economic reality of the long-term investment because the asset concerned is not for sale at the present time, or does not enable measurement of the performance of a long-term investment because the profits or losses made upon disposal of the asset, will never be recorded in an income statement, thus generating doubt over the performance of this investment in the long term.
IFRS 9 also modifies the depreciation rules of financial instruments. In particular, the operative event for depreciation is constituted by actual losses rather than expected losses. Previously, a company waited to observe actual or almost certain default on a loan before depreciating a financial instrument, but now, it must make a provision at the time of purchase or subscription of said instrument, according to the probability of default. The amount of the provision is then increased, if applicable, as the risk evolves. IASB thus requires that provisions are entered into the accounts, taking into consideration prospective economic data reflecting the reality of the economic cycle.

Aside from the accounting standards, prudential standards are also required to respect the principle of actual value or market value. **Solvency II** thus measures the capital requirements of insurance companies according to their assets and liabilities valued at market value. These companies have mainly been impacted by the application of this principle, since most of them used other methods now banned by the regulator, such as historic cost, depreciated cost or amortized cost to valuate the premiums and provisions in their accounts. IFRS 9 also affects bank solvency ratios. According to a study conducted in 2018 by Mazars on the top 30 banks of the STOXX Europe 600 banks index, three quarters of them had suffered a negative impact on their CET1 ratio (-24 bp on average)[36].

4. European Union criticism of IFRS 9

The principle of fair value does not correspond to today's vision of the company. It has a purely financial dimension for shareholders and encourages short-term behavior that is incompatible with the long-term commitments of responsible businesses.

In its 2018 action plan on sustainable finance, the European Commission was very critical of IFRS standards, particularly IFRS 9 which "is seen by many companies as having a negative impact on long-term finance, including both investment and lending. The reason is that current IFRS rules imply more income statement volatility, even if no transactions occur, simply as a result of market movements. Moreover, they add to pro-cyclicality as long-term investors need to integrate short-term market movements and cannot act as stabilizers."

These norms are major hurdles for the transformation of companies that must find long-term financing for transition investments with long-term equity capital instruments valued every year at their fair value. Such principles further weaken companies that are already trying to transform their economic models. Variations in the values of these financial assets are entered into the accounts as equity capital items, while annual provisions for restructuring are entered as charges in the income statement. Furthermore, any profits (or losses) observed at the time of disposal of such assets are never included in the income statement.

This anomaly, identified by the 2018 action plan on sustainable finance, has a particular impact on the energy sector, for which "the difficulty can arise, for example, when companies have to make large provisions related to the winding down of nuclear operations as part of the energy transition, which is something

36 Mazars, *"Quantified impacts of IFRS 9: initial findings"*, 2018.

the regulator can call for. From a business perspective, this may involve long-term investments in equity instruments that would be preferable over debt, given the favorable long-term risk-return profile of equities. The problem is that mark-to market requirements create short-term fluctuations and a reporting maturity mismatch. The European electricity industry, for example, which comprises about 3,500 companies and is critical sector towards achieving carbon neutrality by 2050, has confirmed in the stakeholder consultation that the obligation of mark-to-market valuations has a detrimental impact on their long-term equity investments."

The European Commission's criticism of the IFRS standards also extends to the financing chain, affected by the fact that bank and insurance company solvency ratios are calculated according to IFRS accounting standards. The insurance sector is particularly penalized because *"due to the long-term nature of many its liabilities, [it] could well invest more in equities. But it is obliged through IFRS to report the current market value of its equity investments or to consider (depending on the accounting classification) the equity as 'impaired' in case of a larger downward movement. The features, combined with regulatory requirements under Solvency II, have contributed to the decline in the share invested in equities by European insurance companies, which particularly striking compared with their US counterparts, which have been under a different prudential and accounting regime. For the banking sector, preliminary evidence suggests that the issue may be more relevant for complex lending structures often entailed in infrastructure financing than for standard unsecured loans."*[37]

5. Reform possibilities

Europe must become more influential within IASB and the principle of fair value must be amended.

37 European Commission, *"Action plan: financing sustainable growth"*, 2018.

A more powerful Europe within IASB

Europe is a lightweight within IASB. It has only very moderate influence over the decisions taken. On the IASB board, which counts 14 members, Europe only holds four seats. The ten other members are representatives from Asia (four members), America (four members) and Africa (just one member). The last member of the board is not assigned to any specific geographic area. Of the 22 trustees of the IFRS foundation, the parent entity of IASB, only six are European whilst Asia and America are each represented by six trustees. A single trustee represents Africa and three are not assigned to any specific geographic area. Europe only has 27.3% of the voting rights within the IFRS Foundation and 28.5% of the voting rights in IASB. In view of its very slight political weight, it does not have the power to oppose a norm whose approval by the board requires a positive vote from a super-majority of nine members.

Having entrusted IASB with the drawing up of its accounting standards, the EU should be better represented within the organization and should have more political weight, enabling greater participation in the drawing up of norms. It should not refrain from applying pressure on IASB, whenever necessary, to make IFRS norms more supportive of its own interests and those of its Member States. Similarly, Europe should have the power to approve accounting standards *ex ante*, before they are imposed by IASB, Europe's only recourse currently being to refuse them *ex post*. It should also put forward its own proposals. Europe must therefore agree to finance a study to be carried out by European experts appointed by the European Commission to define a European accounting framework.

Reform of accounting standards

The EU cannot simply admit defeat by declaring, *"not to be in a position to endorse any particular alternative accounting treatment for long-term investments instead of mark-to market valuation"*[38]. On the contrary, it must push IASB to obtain accounting standards that are suited to the long-term commitments of its companies.

38 European Commission, *"Action plan: financing sustainable growth"*, 2018.

The proposals put forward by the EFRAG's secretariat must be examined seriously, particularly those concerning the accounting of long-term financial assets, either historic cost or average fair value. Other methods must also be considered, notably (I) adjusted cost, where the adjustment is based on the proportion of the result of the company held or based on transactions observed on the market, (II) adjusted fair value, or (III) the allocation-based approach.
The conditions of holding long-term financial assets must be a cause for different accounting treatments. Holding shares or other company capital instruments via intermediaries should not result in these investments being excluded from the new perimeter, bearing in mind that IFRS 9 is even more restrictive for investments via intermediaries than for direct investments, because only variations must be entered into the accounts as fair value recognized in profit or loss.
Finally, the rules for calculating provisions must also be re-examined.

RECOMMENDATION: taking back control over the principles that govern European accounting standards within IASB and re-defining a European accounting framework.

To that end:
- The EU must apply pressure, whenever necessary, on IASB to make IFRS norms more supportive of the Union's values and those of its Member States;
- The EU must have the power to approve accounting standards *ex ante*, before they are imposed by IASB;
- The EU must agree to finance a study to be carried out by European experts appointed by the European Commission to define a European accounting framework.

2. Extra-financial communication in support of responsible companies

Contrary to certain claims, i.e. that financial information is complete and that the market price reflects the actual value of a company, the idea that financial information alone does not reflect the reality of a business is now widely shared. Extra-financial information provides a more complete picture for stakeholders. Aside from the fact that it is essential to accomplish the transition to a more sustainable economy, by associating long-term profitability with social justice and environmental protection, extra-financial information helps to evaluate, monitor and manage the social, societal and environmental performance of companies and their impacts on society. Europe is duty-bound to instigate a normalized framework for extra-financial information that is specifically European and represents its values.

1. Europe, pioneer of extra-financial communication

On October 22, 2014, being aware of the importance for companies of being able to communicate information on social and environmental factors in order to identify sustainability risks and boost investor and consumer confidence in companies, the EU adopted directive 2014/95/EU on extra-financial communication, following a proposal from the European Parliament[39]. The directive instructs large companies to draw up an extra-financial statement containing information on the issues of environment, social and personnel topics, respect of human rights and the fight against corruption. This extra-financial statement should also include information on the reasonable diligence procedures implemented by the company and, if relevant, concerning its procurement and subcontractor partners, in order to identity, prevent and attenuate any current or potential negative impacts.

According to the directive, the companies required to draw up this extra-financial statement may rely on the frameworks defined by international organizations, such as the United Nations Global Compact, OECD guidelines for multinational companies, norm ISO 26000, ILO's tripartite declaration of principles concerning multinational enterprises and social policy, the Global Reporting Initiative, etc.

39 Extract from the resolutions of February 6, 2013, on *"Corporate social responsibility: accountable, transparent and responsible business behavior and sustainable growth"* and *"Corporate social responsibility: promoting society's interests and a route to sustainable and inclusive recovery"*.

In June 2017, the directive was completed by non-binding guidelines proposed by the European Commission to help companies to provide high quality, relevant, useful, coherent and comparable extra-financial information concerning environmental, social and governance matters, so as to encourage growth and stable, sustainable employment and to guarantee transparency for stakeholders. The guidelines define six fundamental principles for good extra-financial information:

1. Material,
2. Fair, balanced and understandable,
3. Comprehensive but concise,
4. Strategic and forward-looking,
5. Stakeholder-oriented,
6. Consistent and coherent.

In 2019, following the 2015 Paris Agreement, the publication of Sustainable Development Goals (SDGs) by the United Nations and that of the 2018 action plan for sustainable finance, the European Commission published new non-binding guidelines for companies on extra-financial climate-related information. This information should indicate the main risks that climate change represents for business, the performance and situation of the company, and the risks likely to have a negative impact on climate due to the company's activities.

These guidelines introduce a new element since they define a new two-fold notion of materiality to be taken into account in assessments: financial on the one hand, and social/environmental on the other hand.

Finally, in its final report submitted on March 9, 2020, to the European Commission, the technical expert group (TEG) on sustainable finance recommends that companies employing more than 500 employees communicate on the "green" or "in transition" portion of their activities and investments. These obligations for companies represent a substantial modification to the publication of extra-financial information. At present, companies can define their extra-financial communication choices on the models that provide the most positive vision of their activity. In the future, they will have to demonstrate the proportion of turnover that is related to the green taxonomy, thus highlighting the proportion that is not. It will ultimately be very easy to quantify the portion of a company's activity that is exposed to climate and other such risks.

2. Extra-financial criteria defined by international organizations

The room for maneuver afforded to companies by the European directive in terms of the relevant and useful extra-financial information to be published has left many companies with great uncertainty. Some have turned to the international organizations, other have continued to use a combination of the references proposed by such organizations, mostly of Anglo-Saxon origin. Some of these organizations are oriented towards investors, such as the Sustainability Accounting Standards Board, the Task Force on Climate-related Financial Disclosures, while others are more centered on companies, such as the Global Reporting Initiative (GRI) or the International Integrated Reporting Council. Most of these standards continue to seek financial materiality.

GRI standards

These are the standards most used throughout the world. According to the AMF study, 67% of the companies surveyed referred to the GRI standards[40]. In 2018, the United Nations Global Compact and GRI published a practical guide on integrating the 17 Sustainable Development Goals set by the United Nations into financial information to help companies of all sizes to take them into account in their everyday operations.

Principles for Responsible Investments (PRI)

This organization is supported by the United Nations and financial companies are invited to join (on a voluntary basis) to encourage investors to integrate ESG, in its broadest sense, into the management of their portfolios. PRI encourages

40 AMF French financial market authority, *“Rapport 2019 sur la responsabilité sociale, sociétale et environnementale des sociétés cotées” (2019 report on the social, societal and environmental responsibility of quoted companies)*, 2019.

generalized consideration of extra-financial aspects by all financial sectors. Approximately 2,380 players in the financial sector have so far joined the PRI, representing approximately USD 86.3 trillion in assets under management.

Corporate Reporting Dialogue

To encourage the convergence of extra-financial standards, this initiative brings together various extra-financial communication organizations via the Better Alignment project. The Carbon Disclosure Project, the Climate Disclosure Standards Board, the Financial Accounting Standards Board, GRI and the Sustainability Accounting Standards Board are all members.

3. European extra-financial standards

The multitude of different standards, unequal transposition of directive no. 2014/95/EU on extra-financial communication with the EU, and growing pressure from stakeholders asking companies for more transparency and comparability all push for **the convergence of extra-financial standards.** More than a convergence of standards, what is actually necessary is the harmonization of the methodologies underlying the extra-financial performance indicators. Companies must be able to fulfill the expectations of a highly diverging population of stakeholders, comprising investors, shareholders, financial players, employees, consumers, etc.

Control over these new accounting standards is essential, as demonstrated by the EU's announcement of the revision of the extra-financial reporting directive for 2020, since the practices implemented in the Member States are considered too heterogeneous. At the beginning of 2020, the European Commission's Executive Vice-President Valdis Dombrovskis announced his intention to create an extra-financial reporting standard for companies, which would complement the European plan for sustainable finance by providing investors with more homogeneous information on companies. This announcement is based on the recognition that the non-financial information presented is not sufficiently reliable, comparable or relevant for investors and civil society. It is in this context that the European Commission has launched a consultation to assess the use and legitimacy of benchmarks and their reuse in the creation of a European standard, and to gather the opinions of stakeholders. While acknowledging that the multiplicity of international reporting frameworks and standards creates confusion for companies and investors, the European Commission has set a clear roadmap of "not reinventing the wheel".

Following this consultation, the European Commission adopted a work programme on 27 May 2020, with the aim of proposing to the European Parliament to amend the Extra-financial Communication Directive in the first quarter of 2021. Following this, the Commission mandated the President of EFRAG, on 25 June, to set up a working group with the task of proposing extra-financial reporting standards that will enable companies to communicate on their extra-financial performance in a harmonized format.

France is making an report submitted in June 2019 to the French finance minister by the president of the French Accounting Standards Authority *(Autorité des Normes Comptables)*, Patrick de Cambourg, includes a set of proposals to normalize and improve the general, sectorial and thematic ESG reference systems. As the report suggests, *"Europe can be the land of choice for extra-financial information"*[41].

Europe is not alone in its desire to standardise extra-financial reporting standards. There has been a change in the American approach, moving away from the traditional definition of financial duty for the sole benefit of shareholders, towards the mission, the company's impact on all of its stakeholders and its contribution to common good objectives, as defined by the UN's SDGs. The report ordered by the Davos International Business Council, presided by Brian Moynihan, CEO of Bank of America, and written in collaboration with four major audit firms, Deloitte, EY, KPMG and PwC, on measuring the ESG performance of companies and their contribution to the sustainable development goals, also aims to contribute to international accounting normalization for extra-financial elements.

41 Report presented to the French minister of the economy and finance, "Garantir la pertinence et la qualité de information extra-financière des entreprises : une ambition et un atout pour une Europe durable" (Guaranteeing the relevance and quality of the extra-financial information of companies: an ambition and an asset for a sustainable Europe), Patrick de Cambourg, 2019.

This change in position makes the assertion of European responsible capitalism all the more urgent. This assertion could constitute both an element of citizen identification and a competitive advantage.

RECOMMENDATION: revising the 2014 extra-financial reporting directive to leave the mark of a European responsible capitalism.

This single framework could be a compromise of several current standards. It must enable stakeholders to understand the extra-financial performance of a company easily. Two main ideas should be made clear:

- A responsible company is not one that is satisfied with protecting itself against certain risks, but one that contributes to protect society and its ecosystem;
- A responsible company is one that, beyond having an ambitious ESG policy, also helps to create, protect and promote its intangible assets. These notably include human capital (employee training, the preservation of their employability, the company's educational responsibility, etc.) and innovation capital.

Europe must seize this opportunity to set up a normalized framework for extra-financial information that is specific to Europe and represents its values.

B. Investing responsibly

To enable the development of responsible investment, with the sufficient allocation of financial resources by the markets being a fair condition of public aid, ratings are essential, as is the alignment of companies, asset managers, investors and savers. This alignment depends on the existence of a common understanding of responsible capitalism and a shared and legible measurement system based on the values to which it corresponds, both in terms of the choice of the indicators monitored, and their weighting and interpretation, to enable responsible allocation of resources.

The goal is not necessarily to create a European agency. This is a possibility, but it is difficult to guarantee its success in view of previous failures and the existence of five players of reference that dominate the market – MSCI, Moody's, S&P, Fitch, Morningstar. However, the specific European values liable to encourage the capitalist model to which it aspires must be identified.

These values are not an ideological or moral choice. They comprise the various economic and political choices made by the European nations and by Europe itself over the past fifty years (these values actually being part of a much longer historical continuity):
- Solidarity, which is essential for the stability and serenity of our societies;
- Individual freedom;
- The attention given to our regions and expertise, which can be assets in a context of global competition;
- The contribution to well-being (employment, socialization, availability of services, etc.), explored since the Commission Stiglitz's proposals and the subject of specific OECD analyses;
- Consciousness of the long-term and now, the urgent and related matters of climate and preservation of biodiversity;
- Relations between companies, financial backers, society and the State, able to respond to the challenges of essential common good in an effective, innovative and pragmatic manner (several models actually co-exist in Europe).

These values also appear to be inter-related: for example, we cannot respond to environmental challenges without providing a response to social challenges. This inter-connection of values demands equity in the responses made, in the sense that all stakeholders must find them fair.

This value-based approach is essential, and specifically European. It differs from the Anglo-Saxon approach, which is focused on risk. The risk-based approach is fundamentally valid, but restrictive. It recognizes that the accounts and conventional financial information provided by issuers do not enable sufficient understanding of all risks, notably indirect financial, legal or image-related risks.

Taking the example of climate, the following extra-financial risks can be identified:
- The physical risks that the company might have to face in the future (flooding of facilities, fires, storms, hurricanes, etc.);
- "Carbon transition risks", i.e. those that the public authorities accelerate the transition to lower carbon economies and tax carbon emissions in one way or another;
- The risk that its customers, citizens or NGOs might sue the company for damage to health or to the climate, or the risk of seeing its reputation tarnished, thus affecting its capacity to sell.

This method is mostly limited to the identification of risks; it is not designed to evaluate the business opportunities associated with the major challenges facing society. Above all, it is limited to identifying factors that have a financial materiality. It is often this materiality that determines the extra-financial factors on which issuers and investors will focus, rather than an objective and a priori evaluation of their importance for a given sector, region or economic model. Taking the climate example once again, it is difficult for conventional ESG to evaluate the actual contribution of a company to the implementation of the Paris Agreement or its capacity to seize new opportunities (contracts associated with new modes of consumption and decarbonized technologies, for example). This double filter - risks with financial materiality - also corresponds to an objective: evaluating the company's performance.

However, in a world where technologies and societies are constantly changing, and in which the crisis caused by the Covid-19 epidemic merely amplified this tendency, long-term, responsible investors must be able to evaluate the resilience of the companies in which they invest. Resilience is the company's capacity to perceive current changes, to assess the impacts on its activity and its place in society and to adapt accordingly. It should not be confused with current performance. It is, however, a key element of the preservation of lasting performance.

Responsible capitalism cannot be limited to financial materiality and performance. The ESG approach based on risks with financial materiality that has developed gradually over the past twenty years, certainly provides a useful complement to the accounting and financial information of companies, and has had a very positive influence on the strategies of many companies, while also enabling better allocation of financial resources. However, in order to identify and support true responsible capitalism and meet the expectations of our societies, the actual contribution of companies to the values that define such capitalism must also be recognized. “Conventional” ESG, a natural complement to accounting and financial information and traditional financial analysis, must therefore be developed in this sense. It is a powerful means of assertion for Europe.

The analysis criteria – i.e. the fundamental values of ESG, the resulting rating system with its indicators, priorities and weightings, and its interpretations – have a decisive influence on active management investment decisions, on the profiling of indexes for passive management and on the votes – and even resolutions – of general meetings for issuers. This combination – rating, analysis, voting recommendations – therefore broadly determines the outline of responsible capitalism and the financial resources to be assigned to it.

1. An approach encouraged by European players for more than 20 years

Institutional European investors, particularly from Scandinavia (Swedish and Danish pension funds, Norwegian sovereign funds, for example), as well as institutional investors and bank networks in the Netherlands, France, UK, Germany and Austria in particular, have been expressing stricter and more structured demands in terms of responsible investments, mostly centered on the subjects of ethics and the climate. They have pushed for the development of responsible investment solutions, based on the exclusion of one or more sectors of activity and/or the Best in Class policy (selection of the best and/or exclusion of the worst ranked in each sector). This has resulted in the creation of European extra-financial rating agencies, more or less specialized in their national markets.

Issuers, on the other hand, have been limited by growing extra-financial reporting obligations, such as the 2001 NRE law, Grenelle II in 2010, article 173 of the 2015 law on the energy transition and green growth, the 2019 PACTE law in France and the 2014 extra-financial reporting directive on a European level. Issuers have also gradually come to use the ratings of specialized agencies as performance indicators, particularly if these agencies have set up Best in Class indexes in collaboration with the leading stock exchanges. Examples include the *Dow Jones Sustainability Index* (created in 1999), supplied by the RobecoSAM agency, and a series of Vigeo-Eiris-Euronext indexes launched over the past decade. However, the European agencies have failed to develop a market for ratings sought by issuers.

The national authorities and some ESG ratings agencies have also attempted to create and supply ISR labels, but have met with mitigated success. Institutional investors have barely used them. They are currently enjoying new favor, thanks to the development of the private investor market. National authorities and a number of stock exchange associations support the mandatory nature of “official” labels to be able to present savings products as “responsible” to private individuals. Their arguments are based on transparency and protection of the saver. The reality is often more related to protection of the national market by local players. In any case, it is difficult to see this as the reflection of clearly identified values that might develop and support responsible European capitalism. Finally, they have developed thus far without any European coordination.

2. Reconfiguration of ESG practices and players in progress

Issuers are increasingly critical of the lack of clarity of the ESG rating tables currently used by the specialized agencies and the total opacity of the assessment methods and rating scales. The indicators and weightings are also increasingly unstable over time. This lack of stability increases the workload for issuers responding to evaluation questionnaires. These classifications and ratings are of limited use to issuers, which are unable to deduce specific improvement areas for their practices and strategies.

Investors and bank distribution networks, on the other hand, want to be able to document the impact of their investments and the savings options proposed to their customers. Asset managers are therefore subject to growing demands in terms of reporting and must provide specific, understandable elements on the impacts of the investment choices made. It is important to note the market’s gradual shift towards a desire to measure impact (on value, performance, common good objectives, etc.) rather than compliance with good practices. Extra-financial information clearly lacks coherency and relevance. Robustness, comparability, financial materiality and materiality of impact are essential elements that the agencies struggle to provide. The significance of overall ESG scores is limited due to differences in the collection and identification of indicators, the definition of priorities, the interpretation, the heterogeneity of the information collected, the sheer amount of data, etc. In some cases, these scores are even misleading, because they can mask diverging performance levels for one or more criteria. Finally, the agencies often refuse to share the initial data on which they based their scores, thus increasing the "black box" effect and rendering the task of investors all the more complicated.

The climate issue has certainly accelerated and brought structure to the ESG market over the past five years. COP21 and the 2015 Paris Agreement resulted in an unprecedented mobilization of companies and investors, and encouragement for reports that demonstrate the contribution of companies to 2°C or 1.5°C scenarios (TCFD recommendations). Specialized players have come into being, such as the Carbon Disclosure Project (CDP), for example, for the production of data on carbon footprints. The crisis caused by the Covid-19 epidemic is also likely to result in the promotion of social elements. It is difficult to say whether this will be to the detriment of or in combination with climate commitments, but it is clear that the weighting of social inclusion or social protection criteria in ESG ratings is sure to be revised.

On both sides of the Atlantic, the notion of purpose is also gaining importance. This is totally in line with the shift from compliance-based ESG to impact-based ESG. The Business Roundtable's declaration, in August 2019, on stakeholder-based capitalism and the role of the company in society, also expressed this shift. For the first time, it is clearly considering extending financial duty beyond just shareholders and the importance of the company's purpose. In Europe, the French PACTE law in 2019 marked a first major step, modifying the French civil code and the code of commerce to include consideration of the social and environmental challenges of a company's activity, the possibility of including a purpose in the company's articles of association, and the creation of *"entreprises à mission"* (companies with a purpose). However, it is important to point out that,

historically, the notion of purpose in the USA is more legal and defensive, with the goal of protecting the purpose of a company with fragile and/or dispersed shareholders, while the notion of purpose in France is more proactive, asserting the company's strategic ambition and how it relates to the society(ies) in which it is active. French companies can now claim the status of *"entreprise à mission"*, but the PACTE law also opens much broader possibilities for any company to adopt a purpose.

3. A large market and high commercial and financial stakes

Today, the European market is much more mature, with strong, structured regulatory pressure on both national and European levels. These evolutions are being closely monitored by the whole world, since they are perceived as having a significant potential impact on the issuers and investors of other continents. American players have understood the importance of this market and are looking to control it. Control over the ESG analysis and rating players offers a degree of control over the standards being defined and the economic and capitalist models that best correspond to the American ecosystem.

Over the past four years, and with notable acceleration over the last two, we have witnessed consolidation in the Anglo-Saxon, and particularly American, extra-financial rating market. Credit rating agencies are all developing ESG expertise: Moody's purchased Vigeo Eiris in 2019; S&P acquired the ESG business of RobecoSAM in late 2019; having already bought the British outfit, Trucost, in 2016. Other financial rating or index-producing players have also acquired European expertise: Morningstar purchased 40% of the Dutch firm Sustainalytics in 2017, and the rest of it in 2020; the American extra-financial rating agency ISS bought Ethix (Swedish), then South Pole (Swiss) and Oekom (German) in 2018; the London Stock Exchange acquired the French company, Beyond Ratings, in 2019 to develop its strategy to produce ESG indexes. These players, and among them the largest historic ESG agency, the American MSCI, are thus consolidating the market for ESG investment analysis and recommendations. It is currently estimated that the five largest players control 55% of the extra-financial ratings market.

ESG indexes are important for two reasons: they guide the investments made in passive management (the largest and most dynamic investments at present) and are also closely monitored by issuers (being important for their financing conditions and constituting elements of proof of their CSR performance that are easy to communicate and promote).

Incidentally, the extra-financial analysis and ratings use information that is much more strategic for the company that its accounting and financial results. Such information is often not public, contains key elements concerning the economic models implemented and the strategic and commercial orientations of the company. Such data should not be passed on without second thought to organizations subject to the American authorities and US law. This situation is all the more paradoxical because European companies have thus far led the extra-financial dynamic.

4. The issue of proxies and voting recommendations

Aside from the ESG analysis, we must also consider the voting recommendations at general assembly meetings, which are likely to have a major influence on relations between investors and issuers. This is all the more important since the responsibility of shareholders is to exercise their voting rights at general meetings and to participate fully in the shareholder democracy.

Formerly focused on the governance issues that were traditionally on the agendas of general meetings, today's specialized agencies can pretty well be summed up by two American players: *Institutional Shareholder Services* (ISS) and Glass Lewis, which control more than 95% of the market (the ratio between them being approximately 70/30). ISS is thus, by far, the world's largest agency, providing voting recommendations for more than 40,000 general meetings each year. There are no other players able to compete with them. Only a few small players, often regional or national, remain. Unlike Glass Lewis, which concentrates on analysis and voting recommendations, ISS has also created a huge entry barrier by controlling vote execution, to add to its analysis and recommendations activity.

Vote execution schemes are complex, with a chain of players and contracts signed with all the different marketplaces. The only alternative, which is also Anglo-Saxon and only proposes vote execution and not recommendations, is Broadridge. Other players exist, but they are small and often concentrated on a single region and/or category of issuers.

5. Recommendations

The alignment in favor of responsibility-based capitalism, promoting contributor companies supported by long-term investors, requires an understandable, prioritized ESG rating system that measures impacts and trajectories rather than compliance with a wide range of static, disparate indicators. The ESG rating system must be explicit if it is to be effective and motivating. It must enable easy identification of areas for improvement. It must also clearly evaluate the company's position with respect to society and its direct stakeholders, as well as its solidarity with its stakeholders. The health, social and economic crisis related to the Covid-19 epidemic has shown just how central these elements are to issuers' assessments of resilience.

Europe must take back control over coordination of the extra-financial information required of issuers and used by investors and financial backers. This requires validation of a set of rules and themes, even indicators, and the supervision of extra-financial ratings and voting recommendation agencies.

There are several possible proposals that can be divided into two kinds:

1. The essential values that Europe should promote and on which it can re-establish itself;
2. The way to enable the implementation of these values and the effective promotion of responsible capitalism.

1. What values?

RECOMMENDATION: identifying the key ESG criteria that correspond to the fundamental values of the EU, before selecting their indicators, i.e.:

- **Solidarity;**
- **Individual freedom;**
- **Regional and cultural diversity;**
- **Contribution to well-being (employment, socialization, availability of essential services, etc.);**
- **Preservation of climate and biodiversity;**
- **Cooperation between companies, societies and States centered on fundamental common goods (this cooperation can be measured in terms of companies' "purposes" which should be encouraged);**
- **Role of unions;**
- **Innovation;**
- **Contribution to transitions;**
- **Fairness and compromise in the solutions proposed.**

Based on these cardinal values, the EU must create and finance a working group to define these values, and propose a set of values to be translated into a number of ESG indicators/information categories by the end of the year.

Hereafter, we present a few examples of how the alignment of companies with some of these values can be assessed:

Extending the social fairness requirement to the entire value chain

To measure contributions to the fight against wage inequality, the executive compensation marker can be generalized with publication of the fairness ratio, conditions of access to employment, notably with the diversity of recruited profiles and employee training policies, the conditions of sharing responsibilities

and sharing created value. This is not about eliminating inequalities, but ensuring that they remain fair and within limits that are acceptable to the different stakeholders. The social fairness requirement must be extended throughout the entire value chain. Good governance can be considered more as a means of attaining the objectives of the other two pillars of ESG.

Using ESG as a means of measuring the company's contribution to the evolution of its ecosystem, through adapted governance

ESG has previously been known as a measurement system to identify risks that have a direct or indirect impact on the company's financial performance. We believe, on the contrary, that to support truly responsible companies, reverse logic must be applied: no longer simply identify the risks and try to limit negative impacts, but measure the real contribution of a company to the objectives of all of its stakeholders, while ensuring preservation of the natural environment. Rather than measuring the effects of extra-financial commitments on the financial performance of a company, the company's capacity for resilience should be measured. The level of the company's positive contributions and the governance implemented to maximize these contributions, share them with the various stakeholders, and ensure their compatibility with the expectations of society, thus determine its level of resilience. It is this capacity for adaptation and resilience over time that long-term investors must be able to evaluate.s

Generalizing the "purpose" definition approach and assess the quality of ESG analysis criteria

A company's "purpose", as defined in the French PACTE law of May 22, 2019, is a way for the company to crystallize its strategic commitments with respect to its stakeholders and society in general. The company's resilience can thus be measured based on the quality of its purpose, i.e. the way in which this purpose is defined, governed and implemented and the impact it has.

A few key indicators enable this quality assessment, without going into the details of the company's strategic choices:
- Participation of management and employees, in collaboration with senior management, in its definition;
- Involvement of the board of directors;
- Consultation of other stakeholders;
- Transparency;
- Inclusion in the articles of incorporation;
- Translation into quantified objectives, or renunciations of activities or practices by the company;
- Etc.

Including the notion of transition into ESG.

The impact of investors on the development of a responsible economy will be strengthened if they can assist companies that are in transition. Some are obvious and urgent, like the transition to a low-carbon economy, but today's companies and economies are always in some kind of transition, due to the effects of digitalization and globalization. This is not possible if we satisfy ourselves by only allocating the resources available to the best in class in terms of ESG. We must identify all those undergoing change and which will therefore have a marginal impact on the economy but a larger impact on society. This notion of transition and that of "players of transition" must be placed at the center of this new ESG measurement system. Incidentally, it is included to some extent in the new European green taxonomy, via the notions of "Transition activities" and "Enabling activities".

2. What means?

RECOMMENDATION: making ESG requirements based on a green and social taxonomy a condition for all national or European financial aid.

It is essential that public resources are reserved for responsible players. This orientation has already been more or less confirmed for climate-related issues, for example in the European Green Deal. This must be completed by social issues. The group created in May 2020 by the European Commission on the European Green Deal, presided by Thomas Buberl, could define the list of these conditions and their scope (over and above the simple green condition). The recovery plan proposed by the European Commission and adopted by the Council in July 2020 also makes explicit reference to social imperatives and the notion of economic and social resilience.

RECOMMENDATION: reforming EFRAG so that it includes a European vision of ESG, in compliance with the challenges and values of the European Union.

The scope of the European Financial Reporting Advisory Group (EFRAG), founded in 2001 to express the European voice in the drawing up of international accounting standards and to advise the European Commission on the adoption and implementation of said standards, could be extended to include extra-financial aspects. A technical initiative in this direction was launched in 2019 for climate-related reporting and the proposals of TCFD, as part of the European Lab Project Task Force on Climate Related Reporting, created by EFRAG for this purpose. The mission requested from the EFRAG Board President by the Executive Vice-President of the Commission, Valdis Dombrovskis, in July 2020, clarifies the need to reflect on a potential European extra-financial reference framework and a reform of EFRAG to enable it to assume responsibility in this area over time, if necessary. In order to be effective, these new mandates should be accompanied by a reinforcement of the competencies of EFRAG members concerning ESG criteria and a more political and less technical, more offensive and less passive positioning of the institution. This politicization of EFRAG's role will probably imply a modification of the composition of its Board and its Technical Expert Group. Its general assembly meeting could also be completed by the inclusion of institutions and/or representatives related to ESG topics. Finally, it should be possible for EFRAG to be heard by the Council of the EU and by the European Parliament.

RECOMMENDATION: drawing up a code of conduct for extra-financial rating agencies. A similar approach should also be implemented for proxy advisers.

The European authorities that currently regulate the financial markets and financial players could take on the supervision of extra-financial rating agencies and proxies, based on a code of conduct to be drawn up.

This **code of conduct** could be based on the following criteria:
- Transparency;
- Permanence;
- Qualification of analysts;
- Geographic distribution of analysts and proximity to issuers;
- Prevention of conflicts of interest;
- Availability of primary data;
- Protection of information provided by issuers;
- Etc.

Since this concerns contributors with an impact on market operation and investor protection, it is logical that extra-financial agencies and proxies be regulated by the European Securities and Markets Authority (ESMA).

Furthermore, to ensure true international influence, which is a necessary element of their efficiency, the fundamental ESG values defended by Europe and the debates surrounding the evolution of ESG criteria should be shared with other international institutions. The Impact Management Project group and OECD are suitable candidates, since they already combine private and public institutions, with both financial and extra-financial expertise.

It would also be advisable to encourage the development of an independent European voting recommendation player, whose critical size must be large enough to represent an alternative to the current duopoly.

III

A LEGAL FRAMEWORK FOR RESPONSIBLE COMPANIES

Responsibility is the focal point of company strategy. If we fail to recognize this, we may deprive the company of attractive financing solutions, affecting its stock market value and encouraging hostile action from activist funds that believe that a dynamic ESG policy will create value.

The new factor here is that governments are asking companies to be responsible in exchange for helping them to survive the crisis related to the Covid-19 epidemic. European Union Member States can support their companies without contravening the "State aid" regulations, provided said aids are used to contribute to actions in favor of climate-related objectives[42]*. France is asking the companies in which it holds a stake to integrate "fully and in an exemplary manner the social, societal and environmental responsibility objectives in their ecosystems, notably with regard to the fight against climate change"*[43].

Company responsibility is also at the heart of our everyday lives. It affects our choices as consumers, influences the decisions of young graduates to join a particular company, determines their commitment to said company, etc.

Europe became aware of the importance of the role of the company in society a long time ago. For many years, it has been active to define corporate responsibility. In 1993, Jacques Delors (then President of the European Commission) asked European companies to contribute to the fight against social exclusion, a call that resulted in strong mobilization and the development of European

42 European Commission, *"Press release on the topic of State aid"*, May 8, 2020.
43 Article 22 of French Law no. 2020-473 of April 25, 2020, on finance, amended for 2020.

networks of companies. In March 2000, the European Council meeting in Lisbon made a specific appeal concerning the social responsibilities of companies for the deployment of good practices in the areas of education and life-long training, work organization, equal opportunities, social integration and sustainable development.

In 2001, the European Commission published its Green Paper "Promoting a European framework for Corporate Social Responsibility". Then, in 2011, based on the work of the European Alliance for CSR, it modified its definition of corporate social responsibility to "reaffirm the EU's global influence in this field, enabling the EU to better promote its interests and values in relations with other regions and countries"[44]. This involves evaluating corporate social responsibility "in terms of the effects it has on society" (in social, environmental, ethical matters or topics related to human rights or consumer rights). Companies are thus encouraged to "adopt a long-term strategic approach to CSR, and to explore opportunities for developing innovative products, services and business models that contribute to societal wellbeing" and to "carry out risk-based due diligence, including through their supply chains" to identify, prevent and mitigate the potential negative effects that they may cause.

By affirming that a responsible company contributes to the creation of mutual benefits for its shareholders, its other stakeholders and Society as a whole, the Commission adopts the concept of shared value creation promoted by Michael Porter and Marc Kramer. It thus moves away from Milton Friedman's definition, which states that the company's primary responsibility is to be able to create wealth for its shareholders.

In 2012, the European Commission, being aware that a responsible company must be able to rely on long-term shareholdings, adopted the "action plan on European company law and corporate governance" which proposes "a modern legal framework for more engaged shareholders and sustainable companies". Then, in April 2017, the "Shareholders' Rights Directive 2" (SRD 2) was approved,

44 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of Regions, November 7, 2012.

encouraging shareholders to invest in the long term, improving transparency between investors and issuers and facilitating the exercise of shareholder rights.

For the past decade, Europe has been asking companies to do more than just behave responsibly. They must commit to fighting climate change and make sure that the seventeen Sustainable Development Goals defined by the United Nations can be met by 2030. Echoing the speech on the state of the Union in 2017 by Jean-Claude Juncker, who believed that Europe ought to become the favored destination for sustainable investments and be a pioneer of the fight against climate change, the European Commission presented its action plan for sustainable finance on March 8, 2018, stating that "the financial system could be part of the solution for a greener, more sustainable economy".

A taxonomy of sustainable economic activities was then implemented, proposing a system of asset classification, and thus creating a common language able to guide decision-makers in matters relating to sustainability. An activity is considered sustainable if it (I) contributes to at least one of the six environmental objectives defined by the European Commission[45], (II) does not cause significant damage to any of the six environmental objectives and (III) is exercised in compliance with minimal social and governance norms. On December 18, 2019, the European Commission, European Council and European Parliament agreed on the applicable regulation, thus institutionalizing the requirements and principles of the taxonomy.

The Green Deal, the highlight of Europe's commitment to climate, was published on December 11, 2019. It defines three main goals: to promote the effective use of resources through a clean, circular economy, to restore biodiversity and to reduce pollution.

A responsible company supports and implements a set of fundamental values, notably in the areas of human rights, standards concerning employment, the

45 1) Attenuation of climate change, 2) Adaptation to climate change, 3) Sustainable use of water and marine resources, 4) Transition towards a circular economy, 5) Prevention and reduction of pollution and 6) Protection and restoration of biodiversity and ecosystems.

environment, the fight against corruption, etc. Europe has instructed its European businesses to do more: they must share the value created with stakeholders other than their shareholders and investors, propose solutions to help fight climate change and ensure that the 17 SDGs are met by 2030.

Europe must help and protect its businesses so that they can be responsible, exemplary, committed and attractive, balance their corporate interest (taking into consideration social and environmental challenges of their activities, and the interests of their shareholders), and the right balance between their own and public interests. To overcome the main obstacle, which is the weakness of European shareholdings in the financing of European businesses, a legal and regulatory framework is required to enable these companies to behave in a responsible manner.

A. A harmonized legal framework

The European company must be managed according to its corporate interest, taking into account the social and environmental issues related to its activities, and Europe must encourage all European businesses to define a purpose.

- Being managed according to its corporate interest enables the company to preserve its fundamental interest as a legal entity, independently of the interests of its associates. The company can thus claim its own, superior or independent interest that is separate from the interest of its shareholders, the interest of any of its stakeholders, and the public interest to promote common good, etc.

- Being managed in consideration of the social and environmental issues related to its activity leads the company to measure the social and environmental consequences of its decisions. The company is encouraged to examine the social and environmental impact of its activity in fulfilling its corporate purpose, while weighing this impact against its other interests. Company directors must therefore be provided with the means of considering the social and environmental issues related to the activity before making decisions.

To nourish responsible capitalism, Europe can draw inspiration from France, the country that pioneered the definition of a legal framework for a responsible company (PACTE law).

1. Europe, a breeding ground for responsible capitalism

Within continental Europe, legal cultures are based on Romano-Germanic system with three variations:
- French civil law, inspiring the legal systems in Italy, Belgium, Romania, Spain and Luxembourg;
- German civil law, found in Switzerland, Austria, Estonia, Latvia, Croatia, Slovenia, Greece, Bulgaria, and the Czech Republic;
- Scandinavian civil law (Denmark, Norway, Sweden and Finland).

Two waves of legal changes swept through Europe in the early 21st century. Although they originated in different economic sectors (one from the so-called social economy and the other from the capitalist economy), both have the same goal, i.e. to recognize and develop hybrid companies.

The proliferation of new hybrid company statuses in Europe is rooted in long-standing traditions. At the end of the 18th century and mainly during the 19th, Europe was the land of the social economy, and its mutualist, cooperative models remain widespread, particularly in southern Europe. The first worker cooperatives in Italy and Spain, France's Caisse d'Épargne, and a multitude of economic structures that could be described as "entreprises à mission" (purpose-driven companies), were founded years before their time.

Since the early 1990s, hybrid structures have been popping up throughout Europe, like Italy's social cooperatives, and social-purpose companies in Belgium. In some countries, legislators have attempted to go further, setting a legal framework to define and distinguish social companies. Examples include Community Interest Companies in the UK, *ex lege* social companies in Italy in 2006 and France's Social and Solidarity Economy companies or Solidarity-based Enterprises of Social Utility.

2. Legal innovations from the USA

Europe, a pioneer for having defined the legal framework of a responsible, committed company, must be careful not to allow the innovative models for the societal commitment of companies developed in some American states to take over. Several laws, known as Constituency Statutes, were adopted in the 1980s to promote long-term decisions beneficial to all company stakeholders. These laws enabled company directors and board members to take a number of extra-financial factors into consideration when making management decisions. Faced with widespread criticism based on the weakness of their legal effect, in 2008, Governor Schwarzenegger vetoed the introduction of Constituency Statutes in California, thus limiting their development; however, these statutes continue to be adopted by companies in other States in the USA.

At the same time, at the initiative of the founders of B-Lab, the ***Benefit Corporation* (B-Corp)** was introduced. This legal form is specifically for companies that want to pursue social and environmental goals without their directors having to make decisions that contradict their fiduciary obligations to their capital backers.

The B-Corp community aims to *"get capitalism to evolve"* and to redefine the role of the company in society. Based on the observation that the challenges facing our societies cannot be resolved by governments and non-profit organizations only, the B-Corp community has committed to getting companies to contribute to the fight, serving public interest through their performance. Company must therefore have a legal framework that enables them to fulfill the roles assigned by society: to reduce inequalities and poverty, preserve the environment, make communities more resilient and create better quality employment. The B-Corp community slogan is *"do not seek to be the best company in the world, but the best for the world"*. A large number of European companies, more than a hundred of which are French, are already B-Corp certified.

3. France, a pioneer country within the European Union

Based on the conclusions of the Notat-Senard report[46], French legislators adopted a number of provisions in the sense of their ambition to *"redefine the place of the company in society"*, within the framework of the **PACTE law**; these provisions also correspond to the French President's criticism of an *"ultra-liberal and financial capitalism that is too frequently guided by short-term interests"*. The report's authors claim that the European economy, which has *"distinguished itself with its social and responsible nature"*, now finds itself, in a *"context of financialization of the economy and short-termism of certain investors"*, in opposition to *"Anglo-Saxon capitalism, financialized and without intermediaries, which gives more importance to the role of the market"*.

One of the most emblematic measures of the French PACTE law is the amendment of article 1833 of the French Civil Code, which states that henceforth, any company under civil or commercial law, must be managed according to its corporate interest, in consideration of the social and environmental issues related to its activity. The PACTE law completes the first paragraph of article 1833 of the Civil Code, which states that *"all companies must have a legal purpose and be constituted in the common interest of their associates"*.

The new version of article 1833 of the Civil Code stipulates a fundamental aspect of company management for the first time: the fact that a company is not managed in the interest of specific people, but in its own independent interest and in the pursuit of its own goals. It enables preservation of the fundamental interest of the company, taken as a legal entity, independently of the interests of its associates.

EThis recognition of the notion of corporate interest is accompanied by the principle of *"consideration of the social and environmental issues"* related to the activity exercised by a company, with *"social and environmental"* being understood to have the broadest possible meaning. This addition to article 1833

46 Report submitted to the French Ministries of the Ecological and Solidarity Transition, Justice, Economy and Finances, and Employment, *"L'entreprise, objet d'intérêt collectif"* (The company, a topic of collective interest), Nicole Notat and Jean-Dominique Senard, 2018.

of the Civil Code enables *"indication that all directors must question these issues and examine them carefully in the interest of the company, when making management decisions. If the corporate interest corresponds to the management horizon of a director, the consideration of these issues is a way for the director to estimate the social and environmental consequences of his/her decisions. In other words, this addition indicates that sufficient means must be implemented to enable due and prior consideration of the social and environmental issues related to company's operations when making management decisions, so as not to contradict the corporate interest. This obligation of means does not indicate the orientation or content of the management decision. It is merely a mandatory step of the procedure implemented"*[47].

The EU must take its cue from the French legislation that enables preservation of the long-term interests of companies, the ambition to restore balance to the relationship between shareholders and the statutory governance of the business, the desire for more trust between companies and citizens and the promotion of responsible capitalism. It must enshrine the principle according to which the company is managed, according to its corporate interest, by taking into consideration the social and environmental issues related to its activity, with these consequences being assessed in the broadest possible manner.

B. Europe must encourage European companies to adopt a corporate purpose

The PACTE law also enshrines the concept of "purpose", which "aims to bring company directors and companies closer to their long-term environment. The purpose can therefore have a strategic use, providing a framework for the most important decisions. (…) This draft article thus encourages companies not to be guided solely by "having", but also by a purpose, a productive form of existential questioning, that enables orientation towards the long-term"[48].

47 French Council of State, *"Étude d'impact du projet de loi relatif à la croissance et la transformation des entreprises"* (Impact study on the proposed law on business growth and transformation), June 18, 2018.

48 Presentation of the motivation behind the PACTE law.

A company's purpose is the key element of its image in society and the definition of its commitment to common good. A company that adopts a purpose can thus represent a final goal, an ambition or any other general consideration that supports the affirmation of its long-term values or concerns. It specifies how the company will behave[49] and the values that it intends to promote in implementing its corporate interest[50]. This *"purpose is the motivation, the reason why the company was formed. It determines the direction for company management and defines its identity and vocation. By way of this formal affirmation, the company can define its long-term identity in its articles of incorporation*[51]*"*.

The purpose must serve one or more social or environmental causes. Each of the companies in a group, and even each industrial site of a single company, can thus adopt a purpose related to its own activities, in favor of the ecosystem within which it operates, and the country or geographic area of its location.

RECOMMENDATION: stipulating that a European company must be managed according to its corporate interest in consideration of the social and environmental issues related to its activities, and encouraging all European companies to adopt a "purpose", a key element of their image in society and of the definition of their commitment to common good.

49 Bulletin Joly Sociétés, *"De l'intérêt social à la raison d'être des sociétés"* (From corporate interest to corporate purpose), Didier Poracchia, 2019.

50 Alain Viandier, article quoted, no. 28.

51 French Council of State, *"Étude d'impact sur le projet de loi relatif à la croissance et la transformation des entreprises"* (Impact study on the proposed law on business growth and transformation), June 18, 2018.

C. The directives must leave the Member States less leeway in terms of transposition into national law

Europe must ensure that the rules of responsible capitalism are defined clearly. It must also make sure that the Member States are not left too much leeway to transpose the directives that engage the company's responsibility, thus preventing vagueness in the message addressed to stakeholders who want a single definition to characterize the responsible company, regardless of its nationality.

The Takeover Bid directive - Should the interest of the company take precedence over that of its shareholders?

After 20 years' work and more than 15 years' negotiations between the EU's Member States, with the supporters of a free market economy and "financial" capitalism on one side and those in favor of more controlled, even interventionist models, inspired by the Rhine-model of "social" capitalism on the other, the directive on takeover bids was adopted on April 21, 2004, thanks to the optional transposition of certain principles, including the principle of director neutrality in Article 9 which aims to restrict the powers of the offeree company's management bodies, by banning them from implementing defensive measures designed to prevent the takeover.

Transposition of Article 9 of the Takeover bid directive into the national law of Member Countries is optional, so the countries could either adopt an approach in favor of directors implementing anti-takeover measures, thus protecting the interest of the company over that of its shareholders, or impose a principle of neutrality on its management bodies, stipulating that any defensive measures against a takeover bid must first be approved by the shareholders.

Some countries, including Germany and the Netherlands, opted for the approach enabling directors to implement anti-takeover measures. Supporters of Rhine-model capitalism thus prefer to protect the company's interest over that of its shareholders.

France took the opposite approach, imposing the principle of neutrality on the management bodies of the company, so that defensive measures against a takeover bid must first be authorized by the shareholders, being those most concerned by the offer. Guided by the vision of a corporate interest that is separate from the interest of shareholders, Article 10 of the "Florange law" of March 29, 2014, in complete contradiction with anti-takeover measures, modified the provisions of the French Code of commerce concerning the competence for adopting and determining anti-takeover measures so that the board of directors or directorate, after authorization from the supervisory board of the offeree company, could take any decisions whose implementation might result in the failure of the bid, subject to the powers expressly attributed at general assemblies within the limits of the corporate interest of the company.

The Restructuring and Insolvency directive - Should the interest of the company take precedence over that of its creditors?

The long-awaited Restructuring and Insolvency directive 2019/1023 adopted on June 20, 2019, is the first European text to deal with company bankruptcy. It defines a framework for "preventive" restructuring to be applied before a debtor is formally declared insolvent.

The issue of insolvency is an obstacle to business expansion and cross-border investment. Different and somewhat opaque procedures in the different Member States discourage investment. Better harmonization of insolvency laws is necessary to ensure smooth operation of the single market and the creation of a Capital Markets Union. More convergent insolvency and restructuring procedures are essential to guarantee more legal security for cross-border investors and to encourage restructuring in good time when difficulties arise. The subject of non-performing loans is one of the main concerns of the ECB. Due to the prudential rules applicable, exposure to such loans forces banks to cover their risks, thus mobilizing a portion of their resources and reducing the total amount available for loans by as much. With a limited credit offer, the resources are not allocated to financing innovative companies with the potential to create jobs in the long-term, and the available credit might be allocated to maintaining non-performing companies with large numbers of employees.

The framework proposed by this directive, which corresponds to a global movement to develop preventive procedures without depriving the debtors of their rights, is intended to resolve both of the following:

- The desire of some countries to facilitate refinancing of debtors at equivalent conditions and lowest cost to avoid insolvency situations and the resulting job losses;
- The concerns of other countries that want to facilitate the cleaning up of bank balance sheets by reducing the number of non-performing loans.

In other words, the EU must find a middle road between the supporters of the company's interests and the supporters of the creditors' interests.

The final text is the result of tough negotiations, notably on the rules concerning the suspension of individual lawsuits, the adoption of restructuring plans and the protection of creditor rights. For the European Commission, this directive is mainly intended to harmonize financial restructuring procedures in Europe, broadly based on *Chapter 11* and the *British Scheme of Arrangement*. The European Council wanted more flexibility for national legislation.

The different pressures and aims are the reasons for incomplete harmonization and the hesitations over the final text of the directive, since the Member States can choose between a single public procedure or an out-of-court procedures combined with a brief public procedure for closing.

The Shareholder Rights Directive II – A very strict transposition in France

This directive requires quoted companies to draw up a remuneration policy describing, among other things, the various fixed and variable elements of the remuneration, including all bonuses and benefits of any kind, that can be given to directors. The "say on pay" principle is enshrined, with a double ex ante and ex post vote, which can be either advisory or mandatory.

France transposed the directive in the strictest possible manner, by imposing two annual, binding and non-advisory votes by the general shareholder meeting, prior to any payment, concerning the principles and criteria of determining, distributing and allocating all the component elements of directors' renumeration, and the elements of their remuneration and benefits of any kind paid or allocated during the previous financial year.

D. The company must have a long-term shareholding

The European Commission has been aware of the need to encourage long-term shareholding for several years. A number of initiatives have been taken in this sense, including the adoption of the Shareholders Rights Directive II, which encourages long-term investment by shareholders.

In 2015, the European Parliament also wanted the importance of family businesses to be taken into account. This led the European Commission to examine the legislation concerning such businesses to identify the obstacles to their growth. It found that these businesses deserve particular attention because they *"are more likely to have a long-term orientation, and make an essential contribution to the economy, bringing long-term stability, owing to their social responsibility, high level of responsibility as owners, special degree of commitment to their local and regional communities and economy, and strong values rooted in the European tradition of the 'honourable merchant"*[52].

A long-term shareholding thus implies that the company overcomes at least two obstacles: the increase in its company capital and the financing of its growth. Both are liable to weaken its long-term commitment and social footprint, since these operations are often associated with an opening of capital to shareholders and investors that might be seeking short-term financial performance.

1. Financing dedicated to responsible companies

The taxonomy must not be just green but must also enable responsible

52 European Parliament, *"Report on family businesses in Europe"*, Angelika Niebler, 2015.

companies to access innovative and attractive financing solutions in the form of debt instruments. Lenders will be able to assess a company's responsibility on the basis of the extra-financial information provided.

Like the *green bonds* or *green loans* that finance the acquisition of green assets or the ecological transition of companies, these financing solutions could be provided in the form of debt instruments or bonds whose yield would depend upon the company's social or societal performance. The reimbursement period of such instruments must be compatible with the company's long-term value creation goal.

Banks and insurance companies are an extremely important source of external finance for the European economy, so company responsibility, like durability, should be included in the prudential requirements. The European Commission must examine the possibility of adapting the prudential requirements applicable to banks and insurance companies concerning company capital to finance *responsible* companies if this is justified in terms of risk, while ensuring the preservation of their financial stability.

2. Controlling the evolution of company capital

It is essential that the evolution of company capital is controlled and that long-term shareholders, including employees and particularly the "founding" employees that have contributed to the company's success and want it to preserve its soul and values, are associated in this effort. Shareholder foundations enable preservation of the company model while financing missions of public interest or developing hybrid models.

The European Union must encourage the creation of foundations

Some or all of the capital of many European companies imbued with Rhine-model capitalism is held by a foundation. One thing that Ikea, Bosch, Rolex, Bertelsmann, Velux, Carlsberg, Nokia, Electrolux, Sandoz and Lego have in common is that they are owned by a foundation. This prevents the dispersion of their capital, preserves their societal commitment, ensures long-term management, the funding of missions of public interest, the development of hybrid models to combine profitable and charity activities, facilitates their transmission, and even protects them against hostile capital operations.

The EU could draw inspiration from Denmark, a model country in Europe, where companies held by foundations represent 54% of market capitalization, 10% of national wealth, 18% of value creation, 25% of exports and 60% of the research and development budget. Danish companies are protected against short-term effects thanks to a stable shareholding at the heart of Denmark's redistributive economic system[53].

The European Union must help to eliminate the constraint of forced heirship

The popularity of Danish shareholder foundations is largely facilitated by the absence of provisions in Denmark stipulating that a minimum proportion of an individual's inheritance must be passed on to his/her descendants. However, forced heirship is the rule in many European countries, although the proportions concerned differ. In France, it is 50% in the case of one child, two-thirds if there are two children and three-quarters if there are three or more children. Symmetrically, the free portion is 50% in the case of one child, one-third if there are two children and one quarter if there are three or more children. This is even more complicated in situations of divorce and blended families.

Although exceptions are possible in certain cases, the provisions concerning forced heirship weaken companies, particularly those owned by private entrepreneurs or family groups. Their shareholders cannot pass on a large portion of the capital to their employees, a foundation[54] or other long-term shareholders liable to provide expertise and skills to the company. These companies are therefore often sold, leading to a change in their social commitment and regional presence. In its report on the economic role of foundations, the French General

53 Le Monde, *"L'exemple danois des fondations actionnaires"* (The Danish example of shareholder foundations), August 29, 2018.
54 Institut Montaigne, *"Pourquoi Bill Gates et Warren Buffet ne peuvent pas faire d'émules en France"* (Why there are no Bill Gates and Warren Buffet wanna-bes in France), May 2011.

Inspectorate of Finances[55] described the adverse effects of forced heirship, making several suggestions for reform including a decrease in the maximum rates. This solution has also been envisaged by several senators in a draft law submitted in September 2019 to adapt *"inheritance and donation taxation to the demographic, societal and economic issues of the 21st century"*.

We believe that it is essential to lower or even do away with forced heirship for the sole case of company transmissions. Going beyond, it is important to weigh up the advantages of applying these principles to a company that does not belong to its shareholders or associates, since the latter own shares that represent the legal substance of the company, granting them financial rights and voting rights at shareholder meetings. The tangible and intangible productive assets belong to the company, the employees are the company's employees, the customers have a contractual relationship with the company, which, as a separate legal entity, by nature does not belong to anyone. It is not an ordinary asset (such as a property or a portfolio of transferable securities).

It is difficult, on the one hand, to ask a company not to be managed in the interests of individual people, i.e. its associates, but in its own independent interest and for purposes specific to the company in order to preserve a fundamental interest that is seen as being separate from that of its associates, and, on the other hand, demand that its shareholders or individual associates pass on their shares to their descendants in compliance with the civil code.

RECOMMENDATION: enabling responsible European companies to have long-term European shareholdings. This brings us back to the mobilization of European savings and therefore shareholders that believe in the European values and influence management on the basis of common values.

.../...

55 IGF, *"Le rôle économique des fondations"* (The economic role of foundations), April 2017.

This means:

- That the company must be able to finance itself through innovative debt instruments whose remuneration could depend upon its social or societal impact, like green bonds or green loans;
- Making sure that the prudential requirements concerning company capital applicable to banks and insurance companies are adapted to allow these institutions to finance responsible companies (the responsibility criterion must be taken into account in the same way as the durability criterion);
- Promoting shareholder foundations and making sure that their legal and fiscal frameworks are harmonized;
- Ensuring that company stocks and shares are not subject to forced heirship.

E. European guidelines subject to the same requirements

1. Harmonized governance of companies

Convergence of governance codes within the EU is essential to offer all stakeholders equivalent protection, regardless of the nationality of the company and the location of the market on which it is listed. This must enable harmonization of the criteria concerning the requirements and connecting factors of a code of governance. At present, European governance codes diverge. The *Deutsche Corporate Governance Kodex* applies only to German companies. The *Financial Conduct Authority* imposes compliance with the *UK Corporate Governance Code* as a condition for admission to the *London Stock Exchange*, so it is the listing of a company on the UK stock market that triggers the application of its governance code. Spain and Luxembourg also enable or impose the application of their codes of governance by a foreign company quoted on their stock markets. France has taken a different route, considering that the Afep-Medef code only concerns companies subject to French law and not those quoted on French markets. Thus, the leaving indemnities paid to a director of a Dutch company quoted on stock markets in France and Germany, only come under the Dutch code of governance and not Afep-Medef or Deutsche Corporate Governance Kodex, even though the company is quoted in France and Germany and most of the employees of the group to which it belongs are employed by French or German subsidiaries.

Furthermore, each country adopts different standards. The requirement criteria are therefore quite different from one Member State to another, as noted by AMF in a study published in March 2016 comparing the governance codes applicable in France, Germany, Belgium, Spain, Finland, Italy, Luxembourg, the Netherlands, the UK and Sweden.

It is illusory to imagine that all European companies should comply with the same code of governance. However, the EU must help to harmonize:
- the requirement criteria;
- the connecting factors of a code of governance, which might depend on company nationality, its place of quotation or even regional footprint - the last option would confirm that a company is responsible with respect to its stakeholders and not just its investors.

Applying the code of governance of the country in which the company is registered raises the question of holding companies that own a number of operational subsidiaries in different countries. Applying the code of governance of the place of market quotation favors the company's shareholders and investors, offering them the same protection, regardless of the nationality of the company. Considering that the code of governance of reference is that of the country of the group's operational company with the highest turnover or the most employees, etc. could send a message of "responsibility" to the main stakeholders, notably its employees. The EU must also ensure that the codes of governance of each country promote long-term value creation and enable a company's stakeholders to participate in its governance.

2. A responsible remuneration policy in line with the company's purpose

Directors

The company must be exemplary by adopting a fixed and variable remuneration policy for its directors that responds *"to the interests of the collectivity and* [respects] *a certain number of values, including business ethics and sustainability of development"*[56]. The remuneration of quoted company directors has come under severe criticism in Europe in recent years, resulting in a number of reactions from the European Commission. In 2009[57], it made several recommendations demanding a balance between fixed and variable remuneration and making the attribution of the variable part dependent on predetermined, measurable performance criteria. It also recommended specific limits for leaving indemnities and non-payment in the case of failure. Furthermore, the Shareholders directive II adopted in 2017 requires Member States to include the say on pay procedure in their legislation and demands that companies provide their shareholders with clear, understandable information on the remuneration of their directors, including all the benefits that they received during the previous financial year.

Europe must do more than just make simple recommendations; it must set out the guidelines for a fixed and variable remuneration policy for directors that is responsible, supportive of the social and environmental commitment of the company and in line with its purpose. These guidelines must insist on the fact that the long-term variable remuneration of directors (in the form of performance shares, differed remuneration, long-term remuneration plans, long-term profit-sharing, etc.) depends on the company's long-term social and environmental goals' attainment.

56 Orse (observatory on corporate social responsibility), *"Critères RSE et rémunérations"* (CSR criteria and remuneration), 2017.
57 European Commission, *"Recommendation as regards the regime for the remuneration of directors of listed companies"*, 2009.

Managers

The short - and long-term variable remuneration policy of managers must also be determined, taking into account the attaining of social and environmental goals. This should include the attribution of free shares, stock-options or BSPCEs (company founder share warrants) for companies with a societal impact, the conditions of attribution or exercise of these instruments being dependent on attaining extra-financial societal goals. These value sharing plans must be generalized and opened up to the foreign companies of a group. The company must also orient the collective savings of its employees blocked in PEEs (company savings plans) or similar instruments towards responsible companies or long-term financial instruments.

3. A responsible fiscal policy

The fiscal policy of companies has been severely criticized for many years by many of the stakeholders involved, notably NGOs and consumers who sanction the goods sold or distributed by companies whose “tax behavior” is not seen as responsible or ethical. Aside from tax evasion and optimization attitudes, which are of course reprehensible, some companies are castigated for not paying enough tax on profits in the country in which they are located, without taking into consideration the total amount of this tax which is paid by the group to which they belong. Criticism is mainly aimed at one type of tax, tax on profit, and the company’s contribution to this tax in the country in which it is located.

This minimalist approach has a serious impact on the company’s image and reputation. The situation is amplified by the recommendations of several international organizations concerning transfer price policies. The supporters of this minimalist approach do not consider the production taxes, consumption taxes and social contributions paid by a company and forget that taxable profit is calculated after consideration of these other taxes and social contributions. They also fail to point out that a company pays production taxes and social contributions, often representing very large amounts, even if they do not make any profit.

Supporters of this minimalist approach include the *Global Reporting Initiative* (GRI), whose new norm published in December 2019 recommends that multinational corporations provide more transparency over the profit tax paid and the countries in which it is paid. This norm describes the information to be published in each jurisdiction in which it is present, its tax strategy and governance. It recommends that all companies voluntarily publish a country by country report, i.e. a statement of the transfer prices implemented by multinational corporations in each of the countries in which they are active.

The EU must publish its own guidelines on ethics, governance and tax transparency to enable harmonized practices and ensure that the same requirements are applied everywhere. It should also consider that a multinational group should communicate on its contribution to the public finances of each of the countries in which it is present, as part of a global approach that is not focused purely on profit tax.

4. The same due diligence subject to the same requirements

French and European regulations on due diligence are not effective. They do not prevent third country companies from importing into the European market products that do not comply with reasonable diligence obligations. They do not limit the negative impacts in third countries of international competitors less concerned with responsible business management than EU companies.

The EU must therefore publish its own due diligence guidelines, in consideration of the most commonly used international standards, and notably the OECD guidelines. They must be based on a flexible approach to take into account the different situations faced by companies depending on the sectors and geographic zones of their supply chains. They must also be drawn up in collaboration with European companies. Incidentally, the due diligence obligation should not be associated with a civil liability regime that would result in strong competition distortion for European companies with respect to their external competitors and must not prevent importations from non-European companies that are not responsible.

Finally, the EU must create a European point of contact in charge of boosting the efficacy of these guidelines by implementing promotion actions, responding to information requests and helping to solve the problems raised by their implementation with participation from the business world, worker representative organizations and other non-government organizations.

RECOMMENDATION: establishing European guidelines subject to the same requirements, in the areas of corporate governance, remuneration of directors, tax policy and due diligence.

LIST OF RECOMMENDATIONS

RECOMMENDATION 1: to finance responsible growth in Europe, we must allocate European financial resources to long-term investments:

- **Used to meet the needs for responsible infrastructure and to reduce inequalities between European countries;**
- **Used for investments enabling the ecological transition;**
- **That encourage private investment in responsible infrastructures which are drivers of growth and local development;**
- **Accomplished through investment plans for strategic European infrastructures with concession schemes adapted to the requirements of responsible capitalism.**

RECOMMENDATION 2: using primarily the savings of European households and companies to finance responsible European companies by exploiting the coincidence of the environmental and social transitions.

This will involve:

- Reforming the prudential rules of insurance companies;
- Benefiting from the aging population to steer pension savings towards responsible assets;
- Setting up an extensive European pension system based on a proportion of existing savings invested in the environmental transformation;
- Giving responsible investments a strategic aspect that could limit, prevent and control extra-European equity investments.

RECOMMENDATION 3: investigating the creation of a European pension fund, collecting a portion of household savings and complementing national pension funding solutions. Such a mechanism would allow for Europe to adopt a unified approach to resolving issues of old age. This sovereign fund would be invested in the long-term in responsible companies, with governance rules inspired by German and Swedish funds (joint or mutualist management, priority given to responsible investment, civil society representatives).

Such a fund would enable a portion of the long-term savings of households to be invested in responsible companies.
A system like this would gradually complement life insurance schemes in countries where such schemes are massively used by savers for pension purposes.

RECOMMENDATION 4: taking into account the lessons of the 2020 crisis, adapting the prudential standards applicable to financial activities (Solvency II, Basel III) to encourage long-term investment in responsible capitalism.

a) Solvency II must be reformed to permit more responsible investments in:
- **a.** Large responsible European companies, thus guaranteeing their resilience to enable resistance against international competition;
- **b.** Small and medium-sized companies that produce on a local scale;
- **c.** Long-term investments, by waiving the mark-to-market rule.

b) The Basel Accord resulted in a substantial increase in the capital requirement of European banks, which, unlike American banks, record the majority of the financing of the economy on their balance sheets. In addition, provisioning mechanisms have a procyclical nature. This framework can weigh upon the financing of the economy, even though the ECB relaxed the prudential requirements for company capital during the last period. For many, these agreements are strongly guided by American realities, where the banks are relatively uninvolved in financing the economy and do not record credits on their balance sheet, but sell them on financial markets via securitization. The result in Europe is a constant increase in the company capital of banks and an increase in the cost of credit.

RECOMMENDATION 5: developing the Capital Markets Union for investment in responsible companies at European level and, within this framework, harmonizing the tax rules applicable to the various investment instruments in Europe to determine a European flat tax on financial assets and harmonized bankruptcy laws as quickly as possible.
Transposing the "Restructuring and Insolvency" directive as uniformly as possible in each of the Member States.

RECOMMENDATION 6: creating private equity funds allowing for local investment and that direct the financial savings of one region to the companies of this same region so as to enable the development of local employment.

RECOMMENDATION 7: increasing employee shareholding, notably by harmonizing the rules concerning profit-sharing and investment incentive schemes[58].

58 As we already proposed in our January 2018 report, *"ETI : taille intermédiaire, gros potentiel"*, (ETIs: intermediate size enterprises with huge potential).

RECOMMENDATION 8: defining the terms of a social taxonomy to complement the ecological taxonomy, taking into account health and social concerns.

RECOMMENDATION 9: taking back control over the principles that govern European accounting standards within IASB and re-defining a European accounting framework.

To that end:
- The EU must apply pressure, whenever necessary, on IASB to make IFRS norms more supportive of the Union's values and those of its Member States;
- The EU must have the power to approve accounting standards *ex ante*, before they are imposed by IASB;
- The EU must finance a study to be carried out by European experts appointed by the European Commission to define a European accounting framework.

RECOMMENDATION 10: revising the 2014 extra-financial reporting directive to leave the mark of a European responsible capitalism.

This single framework could be a compromise of several current standards. It must enable stakeholders to understand the extra-financial performance of a company easily. Two main ideas should be made clear:
- A responsible company is not one that is satisfied with protecting itself against certain risks, but one that contributes to protect society and its ecosystem;
- A responsible company is one that, beyond having an ambitious ESG policy, helps to create, protect and promote its intangible assets. These notably include human capital (employee training, the preservation of their employability, the company's educational responsibility, etc.) and innovation capital.

Europe must seize this opportunity to set up a normalized framework for extra-financial information that is specific to Europe and represents its values.

RECOMMENDATION 11: identifying the key ESG criteria that correspond to the fundamental values of the EU, before selecting indicators, i.e.:
- **Solidarity;**
- **Individual freedom;**
- **Regional and cultural diversity;**
- **Contribution to well-being (employment, socialization, availability of essential services, etc.);**
- **Preservation of the climate and biodiversity;**
- **Cooperation between companies, societies and States centered on fundamental common goods (this cooperation can be measured in terms of companies' "purposes" which should be encouraged);**
- **Role of unions;**
- **Innovation;**
- **Contribution to transitions;**
- **Fairness and compromise in the solutions proposed.**

Based on these cardinal values, the European Union must create and finance a working group to define these values, and propose a set of values to be translated into a number of ESG indicators/information categories by the end of the year.

RECOMMENDATION 12: making ESG requirements based on a green and social taxonomy a condition for all national or European financial aid.

It is essential that public resources are reserved for responsible players. This orientation has already been more or less confirmed for climate-related issues, for example in the European Green Deal. This must be completed by social issues. The group created in May 2020 by the European Commission on the European Green Deal, presided by Thomas Buberl, could define the list of these conditions and their scope (over and above the simple green condition). The recovery plan proposed by the European Commission and adopted by the Council in July 2020 also makes explicit reference to social imperatives and the notion of economic and social resilience.

RECOMMENDATION 13: reforming EFRAG so that it includes a European vision of ESG, in compliance with the challenges and values of the European Union.

The scope of the European Financial Reporting Advisory Group (EFRAG), founded in 2001 to express the European voice in the drawing up of international accounting standards and to advise the European Commission on the adoption and implementation of said standards, could be extended to include non-financial aspects. A technical initiative in this direction was launched in 2019 for climate-related reporting and the proposals of TCFD, as part of the European Lab Project Task Force on Climate Related Reporting, created by EFRAG for this purpose. The mission requested from the EFRAG Board President by the Executive Vice-President of the Commission, Valdis Dombrovskis, in July 2020, clarifies the need to reflect on a potential European extra-financial reference framework and a reform of EFRAG to enable it to assume responsibility in this area over time, if necessary. In order to be effective, these new mandates should be accompanied by a reinforcement of the competencies of EFRAG members concerning ESG criteria and a more political and less technical, more offensive and less passive positioning of the institution. This politicization of EFRAG's role will probably imply modification of the composition of its Board and its Technical Expert Group. Its general assembly meeting could also be completed by including institutions and/or representatives related to ESG topics. Finally, it should be possible for EFRAG to be heard by the Council of the EU and by the European Parliament.

RECOMMENDATION 14: drawing up a code of conduct for extra-financial rating agencies. A similar approach should also be implemented for proxy advisers.

The supervision of extra-financial rating agencies and proxies, based on a code of conduct to be drawn up, could be taken on by the European authorities that currently regulate the financial markets and players.

This **code of conduct** could be based on the following criteria:

- Transparency;
- Permanence;
- Qualification of analysts;
- Geographic distribution of analysts and proximity to issuers;
- Prevention of conflicts of interest;
- Availability of primary data;
- Protection of information provided by issuers;
- Etc.

Since this concerns contributors with an impact on market operation and investor protection, it is logical that extra-financial agencies and proxies be regulated by the *European Securities and Markets Authority* (ESMA).

Furthermore, to ensure true international influence, which is a necessary element of their efficiency, the fundamental ESG values defended by Europe and the debates surrounding the evolution of ESG criteria should be shared with other international institutions. The Impact Management Project group and OECD are suitable candidates, since they already combine private and public institutions, with both financial and extra-financial expertise.

It would also be advisable to encourage the development of an independent European voting recommendation player, whose critical size must be large enough to represent an alternative to the current duopoly.

RECOMMENDATION 15: stipulating that a European company must be managed according to its corporate interest in consideration of the social and environmental issues related to its activities, and encouraging all European companies to adopt a "purpose", a key element of their image in society and of the definition of their commitment to common good.

RECOMMENDATION 16: enabling responsible European companies to have long-term European shareholdings. This brings us back to the mobilization of European savings and therefore shareholders that believe in the European values and influence management on the basis of common values.

This means:

- That the company must be able to finance itself through innovative debt instruments whose remuneration could depend upon its social or societal impact, like green bonds or green loans;
- Making sure that the prudential requirements concerning company capital applicable to banks and insurance companies are adapted to allow these institutions to finance responsible companies (the responsibility criterion must be taken into account in the same way as the durability criterion);
- Promoting shareholder foundations and making sure that their legal and fiscal frameworks are harmonized;
- Ensuring that company stocks and shares are not subject to forced heirship.

RECOMMENDATION 17: establishing European guidelines subject to the same requirements, in the areas of corporate governance, remuneration of directors, tax policy and due diligence.

GLOSSARY

AFEP MEDEF code: reference code of governance of companies quoted in France. It defines the principles of proper operation of the company, by introducing rules on the remuneration of directors, inspections and transparency. This code, which was published for the first time in September 2002, is revised regularly.

AMF *(Autorité des Marchés Financiers)*: independent French public authority in charge of ensuring the protection of savings invested in financial products, investor information and proper operation of the markets.

Basel III: regulatory framework for banks and banking activities published by the Governors of the world's major central banks (gathered within the Basel Committee) on 16 December 2010. These agreements aim to strengthen the financial soundness of banks in response to the financial crisis of 2008. This financial strengthening consists mainly in new liquidity ratios for banks, increased capital requirements and better risk coverage.

Book value: value at which an asset is entered into the accounts of a company on the date of joining the company's assets. Assets exchanged for money (purchased) are recorded at their cost of acquisition, freely acquired assets are recorded at their market value and assets produced at their cost of production (Article L123-18 of the French code of commerce).

Capital Markets Union (CMU): European Union initiative to further the integration of the capital markets of EU Member States, to offer new sources of financing to companies (particularly SMEs) and to broaden the investment possibilities for savers throughout the EU.

CDP (formerly the Carbon Disclosure Project): international non-profit organization, founded in 2000, based in the UK. It publishes the environmental impact of the largest corporations and maintains one of the world's largest databases on the environmental performance of businesses.

COP 21: 21st conference of the parties (COP) at the United Nations Framework Convention on Climate Change (UNFCCC), held in Paris from November 30 to December 12, 2015, which resulted in the Paris Agreement on climate.

Crowdfunding: an alternative tool for financing projects outside the traditional circuits. Large numbers of private individuals and/or businesses are invited to provide funds via online platforms. Various forms are possible including donations, interest-bearing loans and stock in the company.

CSR (corporate social responsibility): the practical implementation by companies of sustainable development and the consideration of social and ethical issues in their activities.

Due diligence: process to be implemented by companies to identify, prevent and mitigate the negative impacts of their activities, supply chain and business relations. The *"Due diligence guidance for responsible business conduct"* published in 2018 by OECD makes a number of recommendations to enable companies to avoid and deal with the risks of negative impacts on their workers, human rights, the environment, corruption, consumers and corporate governance related to their activities, supply chain and business relations.

ELTIF (European long-term investment fund): investment fund designed to provide long-term financing to unquoted companies or quoted SMEs for infrastructure projects. To be approved, these funds must invest at least 70% in long-term assets.

ESG: international acronym used by the financial community to designate the Environmental, Social and Governance (ESG) criteria that generally form the three pillars of extra-financial analysis. They are taken into account in socially responsible management. ESG criteria notably enable evaluation of the exercise of a company's responsibility with respect to the environment and its stakeholders (employees, partners, subcontractors and customers).

ETF (Exchange-Traded Fund): investment fund made up of shares or public/private bonds that replicates the performance of a given index. These funds, often referred to as trackers, follow geographic indexes (such as the CAC40) or sector-based indexes. They have developed massively because they are very liquid, highly diversified immediately and carry very little in terms of management costs (passive management).

Extra-financial information: communication of social, environmental, societal and governance information by a company to offer more transparency over its activities, characteristics and organization. As such, it constitutes an important foundation of the corporate social responsibility policy of a company with respect to its stakeholders, citizens and the State.

Fair value: the amount that would be paid for the sale of an asset or for the transfer of a liability in a normal transaction between market parties on the date of the evaluation. The principle of fair value is defined by the IFRS 13 norm at three levels:

- Level 1: assets and liability are evaluated at market price *(mark-to-market)*;
- Level 2: if there is no market, fair value is calculated on the basis of a model *(mark-to-model)* using the observable parameters of a similar market;
- Level 3: if no similar market can be observed, fair value is calculated on the basis of non-observable parameters that are specific to the company.

Financial information: set of official, mandatory communications (balance sheet, income statement, perspectives, etc.) that companies are required to produce. According to Article 4 of Regulation (EC) No. 1606/2002 on the application of international accounting standards, quoted European companies are required to prepare their consolidated accounts according to the international accounting standards adopted by the European Union (IFRS standards). Unquoted French companies must apply the French accounting standards, although they can use the IFRS standards for their consolidated accounts.

Flat tax: system that imposes the same rate of tax to all the members of a group. This tax can be applied to income or financial investments, for example.

Grenelle II: French law of July 12, 2010, on the national commitment in favor of the environment, reinforcing reporting obligations related to the fight against climate change by reducing energy consumption, preventing greenhouse gas emissions and promoting the use of renewable energies.

IASB (International Accounting Standards Board): international organization in charge of drawing up IFRS accounting standards.

IFRS (International Financial Reporting Standards): the international accounting standards for financial information. These standards apply to companies quoted on a European market.

Mark-to-market: method to measure the value of a company's assets based on market values at any given moment.

NGO (non-government organization): non-profit, public interest association that does not depend upon a state or an international institution. An NGO is a legal entity that operates nationally or internationally although it is not a government.

NRE: *Nouvelles Régulations Économiques* (new economic regulations) law of May 15, 2001, requiring quoted companies to produce social and environmental reports for the first time in France.

OECD (Organisation for Economic Cooperation and Development): international organization for economic studies and public policy promotion, whose 37 member countries (in 2020) all have a democratic government system and a market economy.

PACTE law: French law published in the official journal on May 23, 2019, mainly to relax or remove a certain number of formalities required of businesses, and notably SMEs. PACTE is the acronym of *"Plan d'action pour la croissance et la transformation des entreprises"* (action plan for business growth and transformation). The PACTE law notably modified the clauses of Article 1833 of the French civil code, which now states that "the company is managed according to its corporate interest, in consideration of the social and environmental issues related to its activity". It also enabled companies to adopt a mission, created the "entreprise à mission" status (purpose-driven companies) and founded *"fonds de pérennité"* (sustainability funds).

Pension fund: investment fund intended for funded pension systems. It is an investment organization that manages both employee savings and pension payments.

Private equity: private form of investment and direct participation in the capital of a company to finance its development through the provision of non-public capital.

Procyclicity: the positive correlation between the value of an asset, service or economic indicator and the general state of the economy. Procyclicity can cause very significant price variations, depending on whether the economy is expanding or in recession.

Proxies (or *proxy advisors*): agencies proposing voting recommendations and, more generally, corporate governance advice, to which institutional or shareholder investors can entrust their voting choices for shareholder meetings.

Responsible company: a company that supports and implements a set of fundamental values, notably in the areas of human rights, standards concerning employment, the environment, the fight against corruption, etc. It must contribute to the common good of Society.

SDGs (Sustainable Development Goals): 17 sustainable development goals adopted in September 2015 by 193 United Nations countries. Together, they form an action plan in favor of peace, humanity, the planet and prosperity, involving the implementation of multi-stakeholder partnerships. They aim to transform our societies by eradicating poverty and ensuring a fair transition towards sustainable development by 2030. The 17 SDGs form a reference framework for action, an awareness tool for corporate responsibility, a source of economic opportunities and a driver of collaboration. These 17 goals are associated with 169 inter-related targets, addressing all kinds of stakeholders and providing more details on their contents.

SRI (socially responsible investment): systematic and traceable integration of environmental, social and governance (ESG) criteria into financial management and financial investments.

Solvency 2: European directive (2009) harmonizing insurance regulations. It requires insurance companies to hold a sufficient level of capital to deal with systemic risks of insolvency, to control their management and to compute their balance sheets based on market values (mark-to-market).

US GAAP (General Accepted Accounting Principles): accounting standards applicable in the USA.

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THERE IS NO DESIRE MORE NATURAL THAN THE DESIRE FOR KNOWLEDGE

Responsible Capitalism: An Opportunity For Europe

The climate emergency, the challenge of social inequalities and current geopolitical tensions are making Europe focus on a key issue: its independence. How can it be secured in a sustainable and lasting way? This report puts forward a strategy to ensure the independence of European companies and nations through a "responsible capitalism".

Responsible European companies are driven by more than just profit-making. Their primary purpose is the benefit of all their stakeholders, drawing inspiration from the tenets of the social market economy. They must be supported by the savings of Europeans, which have to be more abundant, long-term oriented and in line with European values.

Institut Montaigne and Comité Médicis thus suggest making Europe the home of "responsible capitalism". The 17 recommendations set out in this report aim to reconcile economic, social, environmental and geopolitical objectives around very practical initiatives.

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