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THE EUROPEAN ACTION PLAN, A LABYRINTH WITHOUT BREADCRUMBS TRAIL?

CAROLINE VAN AVERMAET
& JÉRÔME VERHAEGEN

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Authors: Caroline VAN AVERMAET
& Jérôme VERHAEGEN

The idea behind this paper stems from the observation that, for many professionals, the links between the different directives and the goals of the European Commission concerning sustainable finance to address climate change are mostly abstract. Climate change or sustainable finance topics have already been covered in-depth in different articles, but the way they are all interconnected and the coherence that exists between them was less addressed.

Starting from there, the purpose of this document is to review some directives implemented by the European Commission while showing how they are all interrelated and why they were elaborated.

CONTENTS

1. Introduction 7

2. What does ESG stand for? 9

3. Action plan for sustainable finance 10

4. Conclusion 15

5. Sources 16

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1.

INTRODUCTION

«We are the first generation to feel the effect of climate change and the last generation who can do something about it.»

Barack Obama

The first United Nations Convention on Climate Change dates back to 1992. Climate change, has been brought again to the forefront of the political scene but this time by an American leader, President Obama in September **2014**. He stressed the fact that climate change is a social issue with planetary implications and is an issue with significant effects, as confirmed by the IPCC intergovernmental experts.

The **2015** Paris Agreements was an historical turning point, setting an objective on the international political agenda to fight global warming and its harmful effects on the environment, society and businesses. The objective of the agreement was to limit the temperature increase to 2 degrees compared to the pre-industrial era (this figure has been, after a more exhaustive analysis by the scientists, reduced to 1,5°C).

In **2018**, the European Commission, becoming aware of the urgency, adopted its action **plan for sustainable finance** in ten strategical axes. This plan will not only tackle environment issues but also target changes on Social and Governance factors.

The first legislative package of the action plan includes three proposals:

- Establishing a unified EU classification system of sustainable economic activities: the **'taxonomy'**.
- Improving disclosure requirements on how institutional investors integrate Environmental, Social and Governance (ESG) factors in their investment process. Implemented via the Sustainable Finance Disclosure Regulation (SFDR)
- Creating a new category of benchmarks which will help investors compare the carbon footprint of their investments. The first measure creates the EU Climate Transition Benchmark (EU CTB) and EU Paris-aligned Benchmark (EU PAB). The second measure defines Environmental, Social and Governance disclosure requirements for all investments benchmarks. Both measures are not covered in this article.

As part of a second milestone, the April 2021 package, the *Corporate Sustainability Reporting*

Directive **(CSRD)** amends the Non-Financial Reporting Directive (NFRD). CSRD makes sure corporates produce consistent and comparable sustainability information, increasing transparency on corporate performance for all stakeholders.

Consideration of Environmental, Social and Governance criteria, referred to ESG criteria in the article, by a financial institution is necessary to achieve the objectives of the European Commission, but will not be enough to incentivize people to act.

Europe has equipped itself with a regulatory arsenal to promote changes in those ESG criteria and foster transparency at different levels such as company (CSRD) and investment ones (SFDR). The goal is to give decision-makers, whether they are individuals, companies, institutions or politicians, the opportunity to make informed choices. The European Commission, financial intermediaries, companies, rating agencies and individuals must all collaborate to channel public and private money into sustainable finance as well as manage sustainability risks.

All those disclosure requirements imply a significant increase in the need for data, new type of data because non-financial data, as for example quantity of CO_2 emission, number of liters of water consumed, % of woman at a board of director. **Data** will be the **key element** connecting the dots to apply these regulations (taxonomy, SFDR, CSRD) successfully and redirecting cash flows towards sustainable activities. As we will see later on, data generated by compliance to one regulation are used in the others. Compliance with these new regulations requires a huge amount of information, therefore its granularity and quality need to be developed and refined.

This graph shows how, SFDR, CSRD/NFRD and Taxonomy are interconnected and emphasizes the fact that the central point of these directives is the flow of information on non-financial (ESG) criteria.

Figure 1. Scope of Application

LARGE-PUBLIC-INTEREST COMPANIES

All large companies and all listed companies, FI included (except micro-enterprises)

↓

EU TAXONOMY & NFRD/CSRD

Non-Financial Reporting Directive

FINANCIAL INSTITUTIONS

That issue and/or distribute a financial products in the EU

↓

EU TAXONOMY & SFDR

Sustainable Finance Disclosure Regulation

2. WHAT DOES ESG STAND FOR?

ESG. Three letters that bring together Environmental, Social and Governance (ESG) factors to measure the impact of the daily actions and investment choices of companies on society. This view has then been broadened to include the impact society has on companies. It is called **double materiality**; The first type of materiality relates to how a company affects the world; the second type how the world affects a company.

The idea of extending a company's framework of analysis beyond financial aspects was first brought up by John Elkington in 1994 with the concept of «Triple Bottom Line». In addition to the classic accounting bottom line, there are two others to consider: the planet and people.

In terms of corporate investment, these ESG factors, broaden the scope of investment considerations beyond the classic risk/return trade-off. New regulations, such as CSRD and SFDR, aim to bring awareness to companies about the responsibility they have towards society. If they want to survive in the long term, corporates must include, environmental and societal aspects, in their strategy and adopt an adequate governance.

A factor is defined as "a fact or situation that influences the result of something"[1] and criterion as "a standard by which you judge, decide about, or deal with something"[2] . The three ESG factors are broken down into criteria defined by metrics.

Figure 2. The criteria list in not static. An example of this list is shown in the table below, source CFA Institute

ENVIRONMENTAL Conservation of the natural world	**SOCIAL** Consideration of people & relationships	**GOVERNANCE** Standards for running a company
- Climate-change and carbon emissions - Air and water pollution - Biodiversity - Deforestation - Energy efficiency - Waste management - Water scarcity	- Customer satisfaction - Data proctection and privacy - Gender and diversity - Employee engagement - Community relations - Human rights - Labor standards	- Board composition - Audit committee structure - Bribery and corruption - Executive compensation - Lobbying - Political contributions - Whistleblower schemes

1. Definition of Cambridge Dictionary (https://dictionary.cambridge.org/dictionary/english/factor)
2. Definition of Cambridge Dictionary (https://dictionary.cambridge.org/dictionary/english/criterion)

3.

ACTION PLAN FOR SUSTAINABLE FINANCE

This action plan in 10 points sets an EU strategy and roadmap for sustainable finance. These 10 points are split in 3 broad objectives.

I. Reorienting capital flows towards a more sustainable economy

- Establishing a clear and detailed EU taxonomy, a classification system for sustainable activities
- Creating an EU Green Bond Standard and labels for green financial products
- Fostering investment in sustainable projects
- Incorporating sustainability in financial advice
- Developing sustainability benchmarks

II. Mainstreaming sustainability into risk management

- Better integrating sustainability factors in ratings and market research
- Clarifying asset managers' and institutional investors' duties regarding sustainability
- Introducing a 'green supporting factor' in the EU prudential rules for banks and insurance companies

III. Fostering transparency and long-termism

- Strengthening sustainability disclosure and accounting rule-making
- Fostering sustainable corporate governance and attenuating short-termism in capital markets

To achieve its objectives, the European Commission has published guidelines that include, notably, the Taxonomy framework, SFDR and NFRD/CSRD.

3.1 TAXONOMY

Taxonomy is the classification that defines which **activities** (not companies) can be classified as **sustainable** or not from an **environmental point of view**.

The current Taxonomy focuses exclusively on environmental issues but a "Social" Taxonomy is under discussion.

It lists economic activities from specific sectors, with performance criteria for their contribution to 6 environmental objectives which are:

- Climate change mitigation
- Climate change adaptation
- The sustainable use and protection of water and marine resources
- The transition to a circular economy
- Pollution prevention and control
- The protection and restoration of biodiversity and ecosystems

To be considered as green, under the taxonomy, an activity carried out in an eligible sector must comply with the three fundamental points below:

- Substantially contribute to at least one of the six environmental objectives defined earlier

- Do no significantly harm (referred to as DNSH) any of the other five environmental objectives
- Comply with minimum safeguards[3]. Safeguards coming from international rules (the International Bill of Human Rights, the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights, and the Declaration of the International Labour Organization on Fundamental Principles and Rights at Work)

In practice 5 steps are necessary to identify the percentage of activities of a company that are considered as green:

- Identify which economic activities are eligible using the NACE[4] industrial classification system, among macro-sector (containing green activities) and calculate which percentage those activities represent in the company turnover
- Assess which activities contribute substantially to one of the six environmental activities listed above. All or part of the company's activities may contribute.
- Verify if DNSH criteria are met, based on their specific thresholds.
- Assure does it comply or not with minimum safeguards?
- Calculate the percentage of their green activities.

Taxonomy is not a rating or a judgement tool but is a **common language to define if the activity is environmentally sustainable.**

As we will see, the taxonomy is used in disclosure requirements at different levels of the SFRD and the NFRD/CSRD.

3.2 NFRD AMENDED BY CSRD

To foster transparency and good management, and considering that you can only manage what you have measured, the European Commission requires large companies (financial or not) to disclose information on the way they consider Environmental, Social, and Governance factors on an annual basis. This directive from 2014, in place since 2018, is known as the Non-Financial Reporting Directive, presented as an extension of annual financial reporting requirements.

Companies are required to **report** on how **sustainability issues** affect their **business** and the impact of their activities on people and the environment.

The goal is to help investors, society, organizations, consumers, policy makers evaluate the non-financial performance of a company and encourage them to go further in their effort to take into account the ESG criteria in their decisions by requiring more transparency. The types of information to be disclosed are:

- Environmental matters (E)
- Social matters and treatment of employees (S)
- Respect for human rights (S)
- Diversity on company boards (in terms of age, gender, educational background) (S)
- Anti-corruption and bribery (G)

The European Commission gave non mandatory guidelines on each of those subjects. But quickly there was ample evidence that the information companies reported was not comparable, imprecise and especially not sufficient to have a clear view on their non-financial performance, leading to the need to amend the directive to harmonize the ESG data and avoid greenwashing.

3. For more information on Minimum Safeguards see p17 of the report available at https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf
4. The NACE code is a classification system for economic activities with 615 codes

The Corporate Sustainability Reporting Directive – CSRD for short -, which will replace the old NFRD for the 2023 exercise, extends the scope of the companies that must comply to this obligation, and is much more specific about the disclosure requirements. The CSRD also imposes an audit of reported information and the machine readability of the report. This requirement for the companies to digitally 'tag' the reported information will allow easy search and comparison thanks the feeds into the European single access point.

The extra-financial data disclosed by the firm under CSRD will be used for the taxonomy and SFDR. Companies failing to properly apply CSRD could be excluded from the asset allocation of funds products which promote or target Environmental and/or Social characteristics and as such losing part of their financing via equity and bonds, hence the importance of data.

3.3 SFDR

The finance sector was always kept away from discussions about sustainability, as the focus was on the environment and the sector was considered "non-polluting". Thus, there was no reason to focus on it. But in recent years, the European Commission recognized the power that billions of euros invested by financial companies could be of use if invested in the "right" companies. This is the reason why the financial world is targeted in the 2018 action plan.

SFDR stands for Sustainable Finance Disclosure Regulation. All manufacturers of financial products (Financial market participants) and financial advisers are concerned by this directive. Do note that financial market participants refer to entities offering financial products where they manage clients' money such as asset managers and institutional investors.

The regulation addresses **transparency** and **comparability** issues by requiring that EU investors have the **information** they need to make **investment choices** in line with their **sustainability goals**. The target is again to foster transparency on how financial market participants like asset managers and financial advisers integrate sustainability risks and opportunities into their investment decisions and recommendations. SFDR will be implemented in two steps called levels:

Level 1 Transparency on Sustainability risks, Principal Adverse Impacts, ESG approach and positioning of financial products (§6, 8 or 9) applies since March 2021.

Level 2 Regulatory Technical Standards (RTS) developed by the European Supervisory Authorities (ESAs). The Principal Adverse Impact indicators and metrics as well as reporting templates are defined there. Expected to apply from January 2022.

Whereas sustainability factors can have a positive impact and represent an opportunity in investments with ESG objectives, they can also represent a risk embedded in the investment. SFDR requires disclosure on the negative impacts and positive ones when needed.

To do so, SFDR introduces two key elements focusing on the double materiality perspective of negative impacts:

a) **Sustainability risk** defined as « An event or situation in the environmental, social or governance field which, if it occurs, could have a material negative impact on the value of the investment»[5]. The most known being climate risk (physical and transition risks).

b) **PAIs (Principal Adverse Impacts):** refers to the negative consequences of investments based on ESG criteria. Said another way, the

5. Source: Art 2(22) SFDR

negative effects, investments present to environmental, social and governance issues. They are defined by quantitative indicators in the RTS (Regulatory Technical Standards).

a) and b) are part of all the elements that should be disclosed. Disclosures will be required at the entity and at the product level, as well on website, pre-contractual information as on periodic reports.

Disclosures undertaken at entity level are:

- Policies on the integration of sustainability risks in all investment decision-making processes and advice for financial products.
- Statements on due diligence Policies regarding principal adverse impacts on sustainability matters (PAIs). Do market players and financial advisers consider negative externalities on ESG when making investment decision or advice?
- Remuneration policies are consistent with sustainability objective?

Disclosure at entity level is done online.

Disclosures undertaken at product level are:

- Description of the product characteristics and objectives.
- How the product considers PAIs?
- How sustainability risk affects product's value? Assessment methodology and results is disclosed. If not relevant, why it is.

Those requirements are for both ESG-related and non-ESG products.

ESG products are classified by the market player or advisor, as article 6, 8 or 9 products.

Article 8 products **promote** Environmental and/or Social characteristics and give additional information. Information on how promoted characteristics are met and followed in time, as well as information on the percentage of taxonomy compatibility of the product. For example: an equity fund invests in 50 stocks and disclose that 30% of its investments is sustainable from an environmental point of view following the taxonomy. These products may or may not use a benchmark as index references.

Article 9 products **target** sustainable investment, they have sustainability as objective and disclose how it is achieved as well as their percentage of taxonomy compatibility. These products should use a benchmark as index reference.

If the product is neither classified as 8, nor 9 then it is classified as article 6.

Article 6 products **do not take into** account ESG criteria at all or taking them into account but to a limited extent. Example: A fund that takes into account some excluding criteria, as no stock from the weapons industry, but without establishing including one, as focus on renewable energy.

To comply with SFDR disclosures, companies will need to use the Taxonomy framework and rely on the information the investee companies disclose in their CSRD reports. The big challenge of those disclosures will be the gathering of those extra financial data. Data needed for CSRD disclosure but also data needed by financial institutions for their own disclosure requirements under the SFDR. From the quality of the data disclosed by the firm under CSRD will depend the quality of the SFDR reporting and the precision of their reported percentage of green activities under the taxonomy. We are at the beginning of the process but it is expected that as time goes by, the data providers will get better organized.

Figure 3. ESG Regulatory Timeline

SFDR Level 1 published in EU Official journal

End 2019

Level 2 delay communicated

Beginning of October 2020

SFDR First implementation date

10 march 2021

- Product disclosures for both funds and mandates
- Policies

ESAs final report with draft level 2 (RTS) communicated 4 February 2021

1 junuary expected adherence date

Additionnal application dates

30 June 2021 - 31 December 2022

- Policies
- Principal Adverse Impact indicators

4.

CONCLUSION

With climate change concerns growing rapidly, the public opinion has evolved towards more eco-friendly and sustainable decisions and practices. To address this, the European Union released an action plan in 2018 for financing sustainable growth. From the first package came SFDR, CSRD regulations as well as the EU taxonomy, which will allow investors to make informed decisions on whether their investments are sustainable or not. Therefore, data will play a key role by connecting these regulations and will be at the center of future investments decisions. Companies will be pressured to take ESG principles into account and include non-financial data into their reporting, or their relative attractiveness and brand image might suffer. This first package of regulations was a convincing tool to start addressing these generational issues, and one can expect more to come in the foreseeable future.

5.

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About the author

Caroline Van Avermaet, CFA has 17 years of experience in the financial services industry (Banking & Insurance). She has worked with very different financial institution, in Belgium and Luxembourg. Throughout her career, she has been successively, Senior Portfolio Manager, covering UHNWI, working as Asset Manager, Product Manager responsible for investment products and Project Manager in charge of the integration of an asset management software. She has joined Initio in 2021 as senior manager.

Jérôme Verhaegen, CFA has built up an expertise in financial pro-

ducts and client relationships throughout his career in banks and corporations. Starting his career as auditor, he developed in-depth skills around accounting and organizational processes. Working in financial markets brought him knowledge of market behaviors, financial products and portfolio optimization. In his last front office role, he was exposed to treasury management programs. Jérôme is now IT project manager for the Risk department of a Bank. Entrepreneurial, Jérôme is also the co-founder of a start-up. He has joined Initio in 2021 as senior manager.

Square Initio

INITIO BELGIQUE

Boulevard General Wahislaan, 17
Brussels, 1030
Belgium
+32 (0)2 669 77 44
brussels@initio.eu

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square-management.com/initio-belgique