Financing Sustainable Growth in the European Union: Global Lessons

By Mark Bergman and Jean Rogers

As the U.S. Securities and Exchange Commission (the SEC) purposefully takes up the challenge of addressing climate risks and other ESG themes through the lever of disclosure, it is worth bearing in mind that improved disclosure may not only be important from an investment perspective, but it also can be seen as one component of a broader effort to modernize markets and enhance their ability to facilitate the transition to a climate neutral society.

The relevance of disclosure to the achievement of broader societal goals and the many elements of capital markets infrastructure that also must be updated to complement disclosure requirements, are illustrated by the focus in Europe over the past few years on sustainable finance. This comprehensive effort is built on an assemblage of critical interventions, including a unified classification system (or taxonomy) of sustainable economic activity in different sectors, sustainability-related disclosure standards for investors and other market participants, climate benchmarks and climate-related disclosure standards for companies, underpinned by the goal of integrating sustainability risks into investor decisionmaking.[1]

Set out below are the various components that are shaping the sustainable finance landscape in Europe. This multi-pronged effort should be seen, not only as a useful roadmap for global efforts to modernize markets, but also as an illustration of the many moving pieces that need to fall into place to create an economy that functions efficiently in a climate vulnerable world and a market that is attuned to systemic risks and societal concerns.

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European Green Deal

In 2018, the European Commission (the EC) released an **action plan for financing sustainable growth** (the Action Plan), which was a response to recommendations of the High-Level Expert Group on Sustainable Finance issued in early 2018.[2] The Action Plan sets out 10 actions in three key areas that would set in motion legislative action on taxonomy, disclosure and duties for institutional investors and asset managers, benchmarks and corporate disclosure.[3]

These actions are:

- Reorienting capital flows toward sustainable investment to achieve sustainable growth:

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- Taxonomy
- Green bond standards and labels
- Investment in sustainable projects
- Incorporating sustainability in financial advice
- Developing sustainability benchmarks

• Mainstreaming sustainability into risk management

- Integrating sustainability in ratings and market research
- Clarifying duties of asset managers and institutional investors regarding sustainability
- Introducing green supporting factors in prudential rules for banks and insurance companies

• Fostering transparency and long-termism in financial and economic activity

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

In late 2019, the EC announced the **European Green Deal** (the Green Deal), a strategy targeting climate neutrality across the European continent by 2050, and a direct response to the Action Plan.[4] This call to arms followed appeals for accelerated action to reduce greenhouse gas emissions and create a low-carbon and climate resilient economy embedded in the 2015 Paris Agreement on Climate Change, the UN Sustainable Development Goals and the Special Report of the Intergovernmental Panel on Climate Change.

At the heart of the Green Deal is a package of measures to fight climate change, which the EC recognizes requires significant investment, research and innovation, new means of producing and consuming, and changes in the way society travels, works and lives. A critical element of these efforts is to align action in key policy areas, underpinned by legislation and government policy. The efforts are domestic (aligning 27 member states) and global (working through bilateral/multilateral channels to achieve the goals of the Paris Agreement and otherwise promote climate action).

The key policy areas cover energy, the environment, mobility and transport, regional policy and low-carbon economy, industrial policy, trade and sustainable development, international cooperation and development, research and innovation on climate change and sustainable development goals, as well as sustainable finance.

Sustainable Finance

Sustainable finance seeks to support economic growth while reducing threats to the environment and taking account of social and governance factors. It underpins the Green Deal by attempting to channel private investment to the transition effort to achieve a climate-neutral, climate-resilient, resource-efficient, and just economy. The concept calls for taking into account ESG considerations when making investment decisions in the financial sector.

These include:

- Environmental considerations: climate change mitigation and adaptation, as well as the environment more broadly, such as the preservation of biodiversity, pollution prevention and circular economy.
- Social considerations: inequality, inclusiveness, labour relations, investment in human capital and communities, and human rights.
- Governance: can apply to public and private institutions and can play a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process.

Sustainable finance aims to integrate sustainability considerations in a range of activities through key work-streams: corporate disclosure, taxonomy, setting climate benchmarks, enhancing the effectiveness, transparency, comparability and credibility of the market for green and sustainability-linked bonds to encourage issuers to issue and investors to purchase such bonds, and setting forth a framework for sustainability-related disclosures in the financial services sector.

These interlocking building blocks are the product of the following legislative efforts:

- The early cornerstones for disclosure were the **Non-financial reporting directive** (NFRD)[5] adopted in 2014 and the **non-binding Guidelines on non-financial reporting** (the 2017 Guidelines), published by the EC in 2017.[6] The NFRD is currently under review by the EC.
    - The NFRD requires approximately 6,000 EU public companies (with more than 500 employees) to disclose the policies they have in place addressing environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery, and board diversity.
    - The NFRD introduced a double materiality concept: ***financial materiality*** (disclosure is to be provided to the extent information is necessary to understand the risks to a company's "development, performance and position" posed by climate change) and ***environmental and social materiality*** (disclosure is to be provided to the extent information is necessary to understand the impact of a company's activities on climate).

      When assessing the materiality of climate-related information, companies should consider a longer-term time horizon than is traditionally the case for financial information, and should not prematurely conclude that climate is not a material issue just because some climate-related risks are perceived to be long-term in nature. When assessing the materiality of climate-related information, companies should consider their whole value chain, both upstream in the supply-chain and downstream.
    - The NFRD was the first to frame risks to companies in terms of physical risks and transition risks. It also addressed dependencies on natural capital, and human and social capital. Transition risks are risks that arise from the transition to a low-carbon and climate-resilient economy, and cover:
        - Policy risks (*e.g.,* as a result of energy efficiency requirements, carbon-pricing mechanisms that increase fossil fuel prices, or policies to encourage sustainable land use).
        - Legal risks (*e.g.,* the risk of litigation for failing to avoid or minimize adverse impacts on the climate, or failing to adapt to climate change).
        - Technology risks (*e.g.,* if a technology with a less damaging impact on the climate replaces a technology that is more damaging to the climate).
        - Market risks (*e.g.,* if the choices of consumers and business customers shift toward products and services that are less damaging to the climate).
        - Reputational risks (*e.g.,* the difficulty of attracting and retaining customers, employees, business partners and investors if a company has reputation for damaging the climate).

      Physical risks are the risks that arise from the physical effects of climate change, and cover:
        - Acute physical risks, which arise from particular events, especially weather-related events that may damage production facilities and disrupt value chains.
        - Chronic physical risks, which arise from longer-term changes in the climate, such as temperature changes, rising sea levels, reduced water availability, biodiversity

loss and changes in land and soil productivity.

A company with a higher negative impact on the climate would be more exposed to transition risk, while exposure to physical risks would not directly depend on whether or not that company has a negative impact on climate.

- ○ The 2017 Guidelines integrate the 2017 recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and foreshadowed taxonomy.[7] They do not introduce or require the use of a non-financial reporting standard or framework and they do not impose detailed disclosure requirements, such as lists of indicators per sector.

- In January 2019, the European technical experts group (TEG) on sustainable finance published the **Final Report on Climate-related Disclosures**.[8] The TEG was tasked with developing the taxonomy, an EU green bond standard, climate benchmark methodologies and disclosures as well as guidance to improve corporate disclosure of climate-related information.

- The EC published in June 2019 its **Guidelines on non-financial reporting: Supplement on reporting of climate-related information**.[9] These update the 2017 Guidelines, and call for climate-related disclosures in: business model, policies and due diligence, outcome of policies, principal risks and risk management, and key performance indicators. They incorporate TCFD standards as well as GRI, CDP, CDSB, SASB and IIRC standards and frameworks.

- Also in June 2019, the TEG issued the **Final Report on an EU Green Bond Standard**.[10] The EC since has set out proposals for the EU green bond standard in its **Communication on Sustainable Europe Investment Plan**, issued in January 2020.[11]

- In November 2019, the European Union adopted the **Regulation on sustainability-related disclosures in the financial services sector** (SFDR).[12] The SFDR, which applies from March 10, 2021 (with certain requirements to be phased in), introduces disclosure requirements for financial service firms that fit within existing disclosure regimes, and establishes the concept of a "sustainability risk," which it defines as an ESG "event or condition that, if it occurs, could cause a negative material impact on the value of the investment." In brief, it sets out:

  - ○ sustainability disclosure obligations for market participants (asset managers, institutional investors and other entities that offer financial products while managing client money, which it refers to as "financial market participants"), as well as financial advisers in all investment processes, and for financial products that pursue objectives of sustainable investing; and

  - ○ disclosure as to adverse impacts on sustainability (referred to as "principal adverse impacts" or "PAIs" at entity and financial product levels; Table 1 of Annex I of the SFDR RTS (referred to below) lists 18 PAIs).

  These disclosures are to be made in pre-contractual communications, on firm websites and in periodic reports (based on relevant sectoral regulation). And while, on its face, the SFDR targets behavior of asset managers, the effect may be far broader. Asset managers concerned about portfolio holdings could bring pressure on investee companies to make sustainability disclosures (whether or not regulations applicable to any such portfolio company compel such disclosures).

- In July 2020, the **EU Regulation (Taxonomy) on the establishment of a framework to facilitate sustainable investment (TR)**, which was proposed as part of the Action Plan and amended the SFDR, entered into force.[13] The TR sets up a formal, unified and harmonized classification system for environmentally sustainable economic activities, which will be phased in over time. Article 8 of the TR requires in-scope entities, as part of the disclosure required by the NFRD, to disclose how and the extent to which such entities' economic activities are environmentally sustainable. In sum, for an economic activity to be considered environmentally sustainable, it has to:

- substantially contribute to one of the six environmental objectives determined under the TR: climate change mitigation and climate change adaptation (the climate objectives); sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control; and protection and restoration of biodiversity and ecosystems (the "other environmental objectives");

- do no "significant harm" to any of the other objectives;

- be carried out in compliance with minimum social safeguards; and

- comply with technical screening criteria (adopted by the EC as "delegated acts"—*see* Implementing and delegated acts).[14]

This classification system will only enter into effect after the adoption by the EC of the relevant delegated acts, which will determine under what conditions (i) an activity makes a substantial contribution to a given economic objective and (ii) the activity does not significantly harm the other objectives.

The climate objectives are intended to be in place by the end of 2021, with disclosure requirements applicable beginning January 1, 2022, and the other environmental objectives by the end of 2022, with disclosure obligations applicable beginning January 1, 2023. Since the TR (like the SFDR) is a regulation, it applies without the need for national implementing legislation in each EU member state. The United Kingdom can be expected to adopt its own taxonomy based on the TR.

- On February 2, 2021, the European Supervisory Authorities (ESAs) (the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA)) issued their Final Report on draft Regulatory Technical Standards (the SFDR RTS).[15] These standards address content, methodologies and presentation of sustainability-related disclosures under certain articles of the SFDR.

- On February 26, 2021, the ESAs proposed sector-specific key performance indicators for purposes of Article 8 of the SFDR. These would apply to both financial and non-financial entities in the scope of the NFRD. (*See* EMSA final report[16]; EIPOA technical advice[17]; EBA opinion[18]).

- On March 15, 2021, the ESAs issued a joint consultation paper on taxonomy-related sustainability disclosures for products.[19] The consultation seeks input on draft Regulatory Technical Standards regarding disclosures in respect of financial products that invest in economic activities that contribute to an environmental investment objective defined by the TR.

  These standards aim to facilitate disclosures to end investors on investments of financial products in environmentally sustainable activities and create a single rulebook for sustainability disclosures under the SFDR (and both build on the SFDR RTS and create one set of RTS for all environmental taxonomy-related disclosures covering the six objectives of the TR).

  They would do so by requiring disclosures for in-scope products as to how, and to what extent, economic activities funded by the products qualify as environmentally sustainable and how the products are taxonomy-aligned (*i.e.,* a graphical representation of the taxonomy-alignment of investments of the product and a key performance indicator calculation for that alignment; and a statement that the activities funded by the product that qualify as environmentally sustainable are compliant with the criteria of the TR).

- On April 21, 2021, the EC, building upon the TR, the SFRD and the Climate Benchmark

Regulation that has applied since December 2020, announced perhaps its most ambitious package of measures aimed at making the finance sector more sustainable. The package, billed as helping improve the flow of money towards sustainable activities across the EU to make Europe climate neutral by 2050, includes the proposed **EU Taxonomy Climate Delegated Acts**, a proposed **Corporate Sustainability Reporting Directive** (the "CSRD") and six amending Delegate Acts.[20] In sum:

- o the Taxonomy Climate Delegated Acts would classify which activities best contribute to mitigating and adapting to the effects of climate change - lists a number of economic activities in sectors covering the large majority of EU carbon emissions and sets criteria to determine whether each activity can be considered to make a substantial contribution to climate change mitigation and climate change adaptation, and to do no significant harm to environmental objectives;
- o the proposed CSRD, which would revise and strengthen the rules introduced by the NFRD, would require listed companies (other than micro-enterprises) and "large" companies in the EU (49,000 in total) to provide consistent and comparable sustainability information;
- o the proposed amending Delegated Acts on fiduciary duties, investment and insurance advice, and investment and insurance product oversight and governance, are intended to ensure that financial firms, such as advisers, asset managers or insurers, include sustainability in their procedures and their investment advice to clients.

- In the wings is the **renewed sustainable finance strategy**, which builds on the foregoing efforts and is to set out a roadmap for new actions to increase private investment in sustainable projects and support the Green Deal as well as manage and integrate climate and environment risks.[21] It is expected to be adopted in the first half of 2021.

Next Steps

The EC recognizes that its sustainability efforts are complex and multi-faceted. It is also cognizant of the fact that there is increasing demand for non-financial information from investors and companies, driven by investors demanding better information to assess financial risks posed by sustainability considerations and by the growth in financial products that actively seek to address ESG issues. At the same time, the SFDR just came into effect and the TR comes into effect shortly, but they can only meet their stated goals if more and better decision-useful non-financial information is available from companies.

The view emerging from EC consultation on revising the NFRD is that the publicly available information about how non-financial issues, especially sustainability, impact companies and how companies themselves impact society and the environment is inadequate.

Respondents were of the view that non-financial information is not sufficiently comparable or reliable; companies do not report all information that users think is necessary, and many companies report information that users do not think is relevant. Some do not disclose any information, and investors find it difficult to find non-financial information even when it is reported.

Companies incur unnecessary costs related to reporting non-financial information. Companies face uncertainty and complexity when deciding what information to report, and how and where to report such information. In the case of some financial sector companies, this complexity may also arise from different disclosure requirements in different EU legislation. Companies are under pressure to respond to additional demands for non-financial information from sustainability rating agencies, data providers and civil society, irrespective of the information they publish as a result of the NFRD.

The EC is focused on revising the NFRD, and a roadmap for the revisions was set out in February in the Final Report on Proposals for a relevant and dynamic EU sustainability reporting standard-setting, prepared by the

European Financial Reporting Advisory Group (EFRAG).[22] The Final Report proposes a sustainability reporting standard-setting regime to develop comprehensive and coherent standards with layers of reporting (sector-agnostic, sector-specific, and entity-specific). The CSRD and the other proposed initiatives announced on April 21 underscore the importance of corporate reporting as a key pillar in the effort to make Europe climate neutral by 2050; this comprehensive sustainability framework ensures the transition in finance (enabling a reorientation of investments) and prevents greenwashing.

In these endeavors, the EC is by no means acting in a vacuum. In the past few weeks alone, the IFRS Foundation Trustees have weighed in on the need for global sustainability reporting standards, building on the work of the TCFD and leading standard-setters (CDP, CDSB, IIRC, and SASB), and IOSCO announced plans to present a proposal to COP26 that would form the basis of national requirements to address greenwashing.

All to say that the success of the European project very much depends on addressing perceived failings of the current disclosure landscape as set out above. Those seeking to create similar disclosure regimes (including the SEC), as part of a broader sustainable finance effort, would be well advised to consider the multiple efforts still in the process of being rolled out in the European Union.

Notes

1. *See* the "European Commission Fact Sheet: Financing Sustainable Growth" (June 2019), available at *https://ec.europa.eu/info/sites/info/files/business_economy_euro/accounting_and_taxes/documents/190618-sustainable-finance-factsheet_en.pdf*.

2. *See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097*.

3. *See* the European Commission update at *https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en*.

4. *https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1596443911913&uri=CELEX:52019DC0640#document2*.

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15. *https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2021/962778/JC%202021%2003%20-%20Joint%20ESAs%20Final%20Report%20on%20RTS%20under%20SFDR.pdf*.

16. *https://www.esma.europa.eu/sites/default/files/library/esma30-379-471_final_report_-_advice_on_article_8_of_the_taxonomy_regulation.pdf*.

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