Crunch time: the EU sustainable finance agenda meets the real economy

BRUNSWICK

Companies around the world are facing a moment of truth regarding the sustainability of their operations. Driven by a combination of regulation, investor and/or peer pressure, the ESG agenda has morphed into sustainable finance regulations that are rapidly permeating all areas of economic activity.

This is primarily a consequence of the climate emergency, which requires an unprecedented funding effort to re-engineer the global economic system. The Financial Stability Board estimates global investment of $1 trillion per year is required, while the European Commission estimates that at least an additional €180 billion per year is needed in Europe.

But the Covid-19 pandemic and the subsequent need to achieve a fair economic recovery (under the theme of 'build back better') have also highlighted the social and governance dimensions of sustainable finance underpinning the EU's policy-making. To some extent these aspirations are not new. The integration of ESG factors in the investment process has been championed by a proactive community of institutional asset managers and asset owners for the last 15 years (led by the UN-backed Principles for Responsible Investment). What is new however is that regulation is helping embed these expectations across the financial system and, by implication, the broader economy.

Multiple and cross-cutting regulatory requirements are becoming interwoven with competitive pressures, investors' agendas, and broader reputational risk. The level of granularity and scrutiny around climate in particular means that reliance on high level CSR-style narratives that may have been deployed in the ESG space is no longer an option. Adapting to these new and multiple pressures will often dovetail for individual companies with a wholesale review of their corporate strategy and purpose.

The first elements of the EU sustainable finance agenda (proposed in 2018) have already enacted into law (albeit without their detailed rules or implementing legislation which is still under construction). The fact that the primary legislation is already in place however, has important implications both in terms of the extraterritorial reach of these laws (the so-called 'Brussels effect'), and how that will evolve as sustainable finance regulations in other countries are developed and come online, as well as substantive lessons that can be learned by other jurisdictions regarding the design and scope of their own statutory requirements.

While the EU has long been a first mover on sustainable finance, this is increasingly becoming a global agenda. The G7 Finance Ministers meeting in June agreed 'to move towards mandatory climate-related financial disclosures that provide consistent and decision-useful information for market participants and that are based on the Task Force on Climate-related Financial Disclosures (TCFD) framework, in line with domestic regulatory frameworks.' They also acknowledged the need to agree 'a baseline global reporting standard for sustainability,' so that these disclosures yield consistent and decision-relevant information.

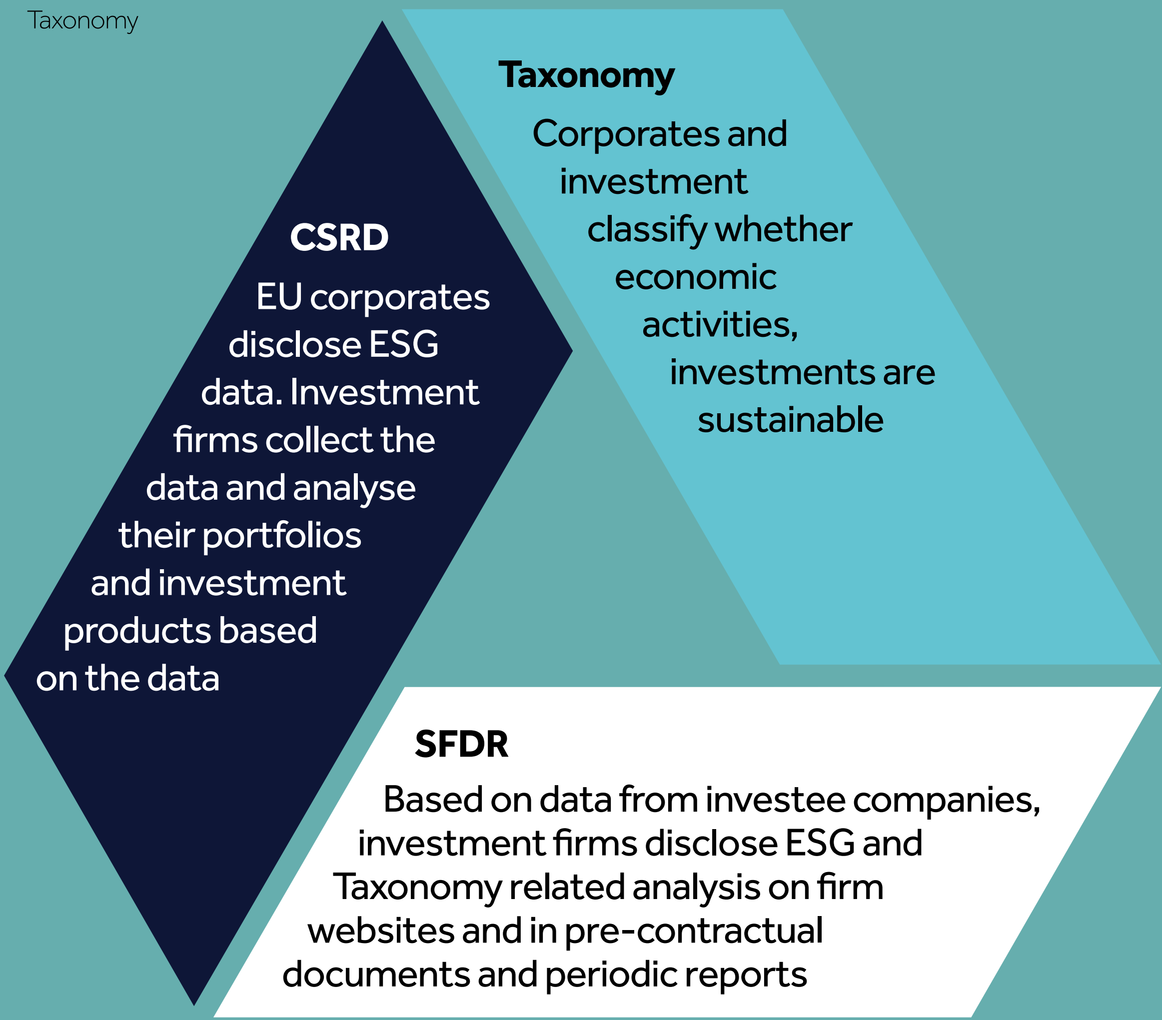
The finance sector is under pressure to redirect capital and put it to more sustainable uses. This in turn has put the spotlight on companies and how they are responding to these pressures and navigating this complex and fraught business environment.

The EU as first mover

For the past few years, the EU has been engaged in a regulatory push to mandate 'sustainable' finance as a means of helping meet their obligations under the Paris Climate Agreement. The EU's leadership in this field has been likened to that of the General Data Protection Regulation (EU GDPR). Companies with a presence in Europe need to understand the full implications of these disruptive new rules.

Following the principled approach of the Task Force on Climate-related Financial Disclosures (TCFD), disclosure has been the main pillar of this EU agenda, firstly for investors under the Sustainable Finance Disclosure Regulation (SFDR) and secondly for a broader range of investee companies under the Corporate Sustainability Reporting Directive (CSRD). These initiatives have been bracketed by a complex and high technical 'taxonomy' to identify what can be considered 'sustainable' economic activity.

Figure 1: The three pillars: SFDR, CSRD (revised NFRD) and the Taxonomy



Source: FactSet https://insight.factset.com/eu-taxonomy-regulation

This reallocation of capital required to transition to a low carbon economy involves systemic changes and disruption in the short, medium and long term that extend well beyond sectors heavily reliant on fossil fuels. While the EU's regulatory intervention is aimed primarily at private capital, it will also impact the allocation of public funding post-pandemic (green bond standards, recovery fund requirements, procurement and tendering, etc.) including for a 'Just Transition' and investments in developing economies.

The detail and timing of EU regulatory requirements has yet to be finalised (the 'implementing legislation'). However, faced with new legal obligations under the SFDR, global investors already expect investee companies to have embraced the fundamentals of ESG disclosures and sustainable finance. Laggards risk being dropped by investors, reputational damage and compromising their access to capital.

Key stakeholders, from consumers and employees to clients and suppliers, are also engaging on these issues and reacting in ways that are impacting both other companies up and down the supply chain as well as the broader competitive landscape. Thus, the impact of the incomplete EU regulation is being bracketed or reinforced by two other key trends; **growing investor activism** in this space and the **escalating emission reductions targets** required from signatories to the 2016 Paris Climate Agreement.

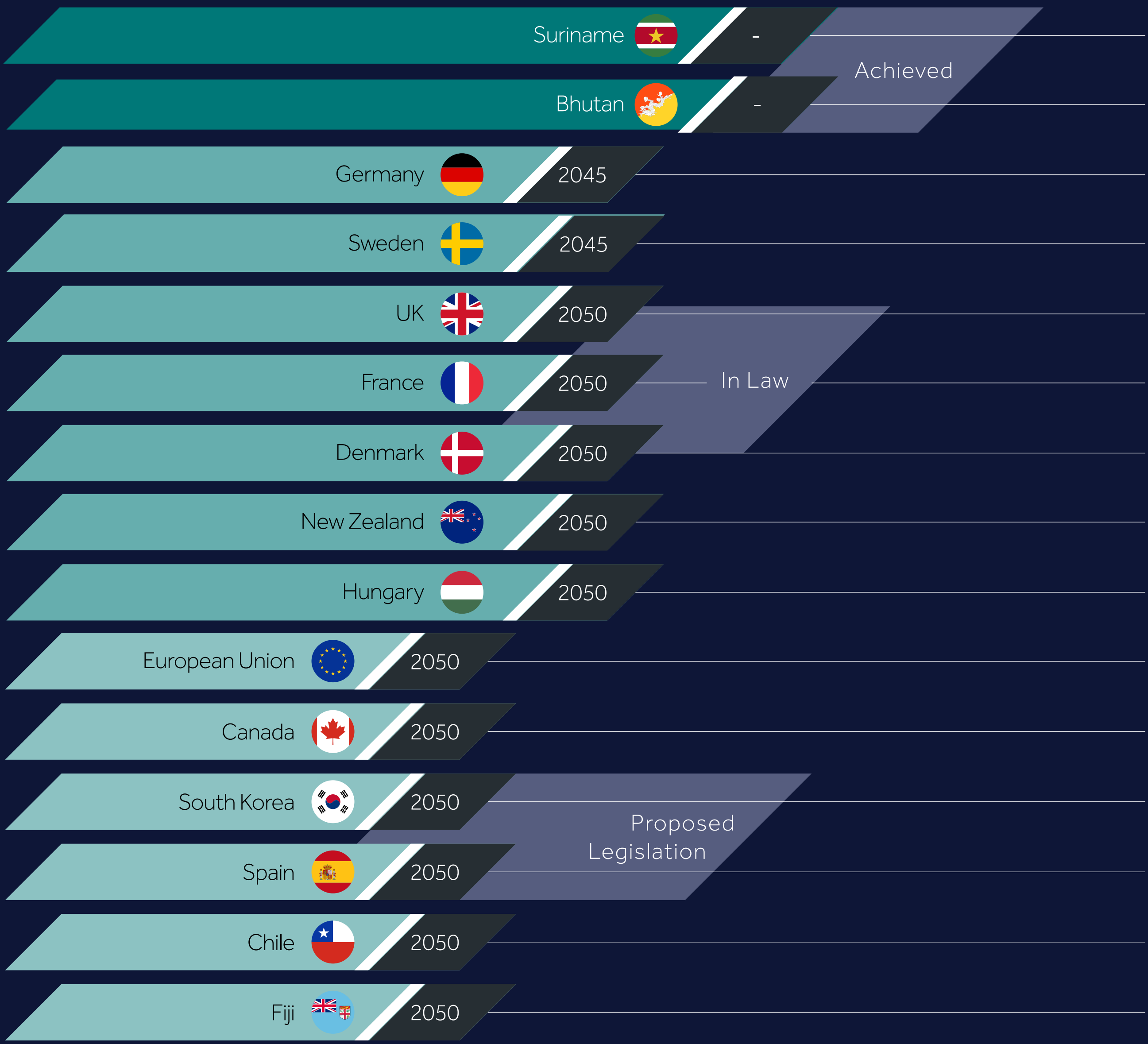
Firstly, the voice of investors on these issues, is becoming increasingly influential. Shareholder proposals asking oil and gas companies to disclose their alignment with the Paris Agreement goals have garnered record support this year. Some of them passed with overwhelming majority votes (e.g. Chevron, 61% or ConocoPhillips, 58%). But the engagement is constant across sectors and off AGM season, through collective investor initiatives such as Climate Action 100+, and individually by institutional investors who have effective stewardship programs in place.

A new breed of ESG activism is also setting foot in the governance space through the collaboration between institutional investors and NGOs (e.g. ShareAction or Follow This) as well as with new investment firms taking a stance on financially material ESG issues. Indeed, a highlight of this AGM season has been the proxy contest between Exxon's management and hedge fund Engine No.1 who managed to place three directors to the board.

Similarly, the Say on Climate campaign led by another hedge fund The Children's Investment Management and its philanthropic arm, has added complexity to companies navigating the proxy season. In addition, traditional ethical and faith-based investors have continued their values-driven engagement.

Secondly, this agenda has become increasingly global as more and more countries commit to demanding emissions reductions targets (below Figure 1). This has led to these jurisdictions also consider the various policies they will need to adopt to reach these targets, with the two central planks being mandatory climate-related disclosure and taxonomies.

Figure 2: Net zero emissions targets by leading jurisdictions[1]



Source: Net Zero Tracker, Energy & Climate Intelligence Unit https://eciu.net/netzerotracker

[1]As of 2 June 2021, 59 countries representing 54% of global GHG emissions have communicated net-zero targets https://www.wri.org/events/2021/6/net-zero-targets-which-countries-have-them-and-how-they-stack

The EU sustainable finance agenda: Three main pillars

The EU sustainable finance agenda has three interconnected legislative pillars: disclosure requirements for investors, a Taxonomy or classification of sustainable economic activities, and disclosure requirements for companies.

It is almost five years since the European Commission created a High-Level Expert Group (HLEG) on Sustainable Finance to provide advice on a range of issues including how to:

- steer the flow of public and private capital towards sustainable investments,
- tackle perception of greenwashing around 'sustainable' products and marketing, and
- identify the steps that financial institutions and supervisors should take to identify and manage ESG-related risks.

The HLEG was made up of 20 senior experts from civil society, the finance sector, academia and observers from European and international institutions. The group issued its final report in January 2018 and the first package of proposals based on its recommendations were tabled by the Commission shortly thereafter. While the Commission's package contained almost a dozen measures the two key legislative proposals were:

- to create a methodology to classify the sustainability of the full range of economic activities (the EU Taxonomy Regulation); and,
- to codify asset managers' and institutional investors' duties regarding sustainability (the EU Sustainable Finance Disclosure Regulation).

Figure 3: Elements of the March 2018 Sustainable Finance Action Plan

Source: Irish Funds https://www.irishfunds.ie/regulatory-technical/sustainable-finance

Even though the detailed implementing rules for these two regulations are still being hammered out, the legislative process for both proposals was completed in 2020 and they have since become law. The requirements placed on asset managers under the Sustainable Finance Disclosure Regulation (SFDR) are now being codified for investee companies under the Corporate Sustainability Reporting Directive (CSRD), proposed by the European Commission in April 2021.

The EU Taxonomy Regulation

The Taxonomy Regulation (TR) establishes an EU-wide classification system of environmentally sustainable economic activities according to six environmental objectives (see below table). It also recognises 'transitional activities' (where there are no or insufficient low-carbon alternatives: for example building renovation, electricity generation up to 100 gr CO2/kWh, or cars generating less than 50 gr CO2/km) and as 'enabling' activities (high-carbon activities needed to transform to low-carbon: for example the construction and operation of infrastructure for low carbon land transport). Its purpose is to harmonise the definition of environmentally sustainable or 'green' economic activities.

Date	SFDR (investors)	CSRD (corporates)	Taxonomy (defining green investment)
May-18	Legislative proposal from EC		Legislative proposal from EC
09-Dec-19	Regulation published in OJ		
22-Jun-20			Regulation published in the OJ
12-Jul-20			Entered into force
10-Mar-21	Primary legislation in effect		
21-Apr-21		Legislative proposal from EC	Implementing legislation (first 2 DAs) published
30-Jun	Investors start to report on policies in place to address adverse impacts		Deadline for co-legislator objections
End 2021			EC to publish 4 other DAs
01-Jan-22			Implementing rules (first 2 DAs) will apply
01-Jul-22	Implementing rules (DA) will apply	Earliest conclusion legis process	
Sep-22		First set of reporting standards from EFRAG	
End 2022	Evaluation and review by the EC	First standards adopted by EC	
01-Jan-23			Implementing rules (4 other DAs) will apply
01-Jan-24		Companies apply EC standards for 1st reporting FY2023	

DA = Delegated Act

The technical screening criteria (implementing rules) for the Taxonomy objectives of climate change adaptation and mitigation were due by the end of 2020 but have been held up by pitched political battles around whether natural gas and nuclear energy can be considered Taxonomy-compliant. Critics argue that GHG emissions from gas-fired power plants are far too high and incompatible with a carbon-neutral future. Nuclear energy on the other hand is considered by many as incompatible with the Taxonomy's catch-all criteria that technologies deployed 'do not significant harm' to the environmental objectives underpinning the taxonomy. The screening criteria for the other four objectives are due by end 2022.

Once complete the taxonomy will be used for a wide range of financial instruments and purposes including retail product labels, green bonds, green benchmarks, etc. Taxonomies are increasingly being seen as essential anchor for green finance initiatives; numerous jurisdictions including Japan, China, and the UK are well advanced in the development of their own taxonomies, and both the World Bank and the OECD have produced guides on how to develop these.[2]

Figure 4: The six Taxonomy objectives and technical screening criteria

1. Economic activities should make a substantive contribution to one of six environmental objectives

- Climate change mitigation
- Climate change adaptation
- Sustainable and protection of water and marine resources
- Transition to a circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

2. Do no significant harm (DNSH) to the other five; and

3. Meet minimum safeguards (e.g., OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights)

[2] https://www.oecd.org/environment/developing-sustainable-finance-definitions-and-taxonomies-134a2dbe-en.htm; https://documents1.worldbank.org/curated/en/953011593410423487/pdf/Developing-a-National-Green-Taxonomy-A-World-Bank-Guide.pdf

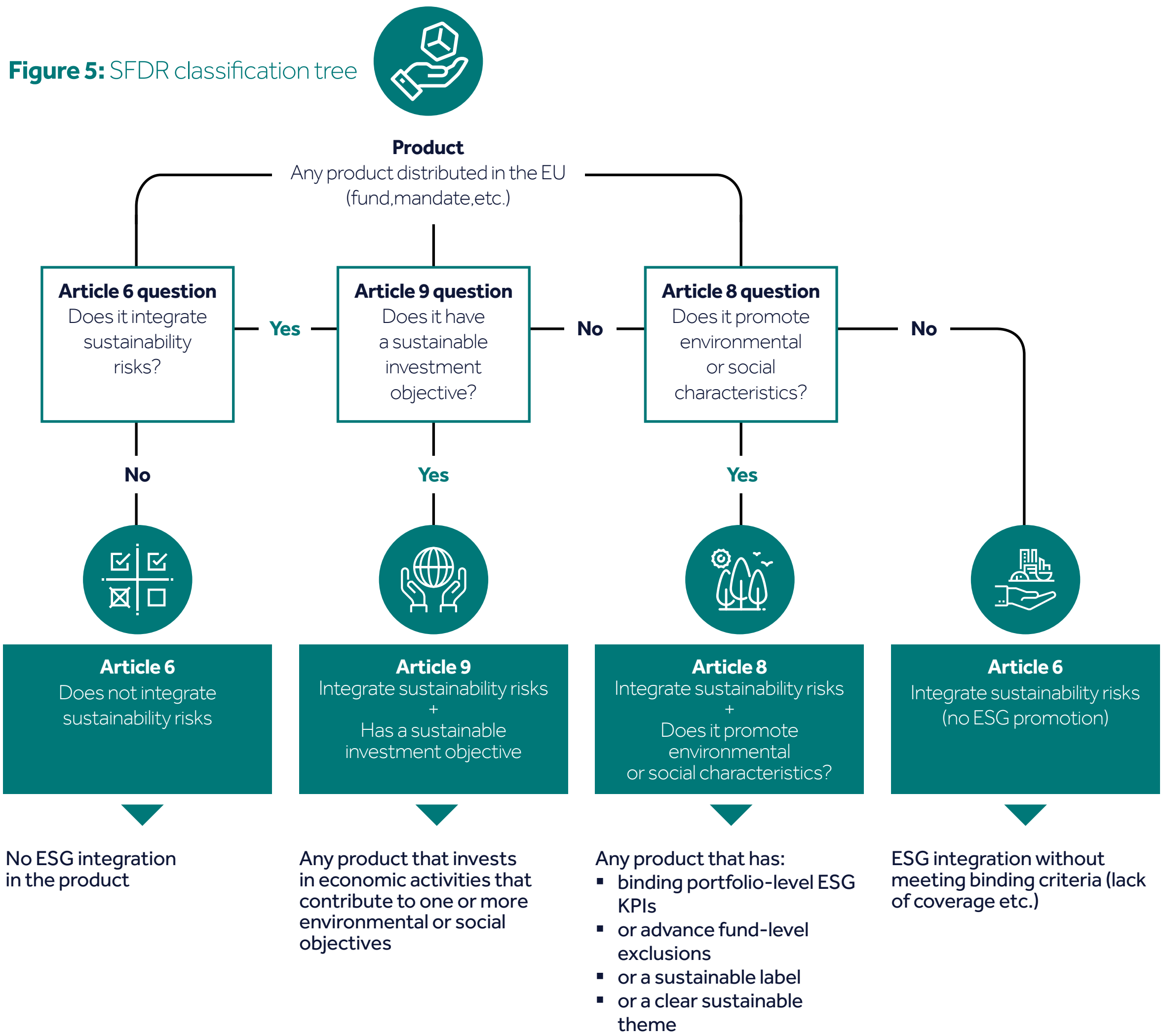
Source: TEG Report 2020

The Sustainable Finance Disclosure Regulation

Institutional investors are central to the EU agenda as they allocate and manage capital to fund the energy transition. Under the SFDR, all investors (including all the big US asset managers) holding an EU license will be required to disclose whether their financial products fall into three categories aimed at avoiding greenwashing.

First, products that promote environmental or social characteristics (Article 8 SFRD). Second, a tougher level comprising financial products that target sustainable investments (Article 9 SFRD). Third, products that do not integrate any kind of sustainability into the investment process (Article 6 SFRD).

Figure 5: SFDR classification tree



Source: BNP Paribas AM
https://www.bnpparibas-am.com/wp-content/uploads/sites/1/2021/03/SFDR-Decision-Tree-EN-scaled.jpg

In addition, the Taxonomy Regulation requires all organisations in scope of the Non-financial Reporting Directive (NFRD), including large banks and insurers, to report the taxonomy compliant proportion of their capex and opex, with a phased in application from 1 January 2023 to full application from 1 January 2025.

This has brought a great deal of pressure to bear on asset managers and institutional investors who will shortly be legally required to disclose information about their portfolios/ investee companies that in many cases does not exist.

The investors concerned in many cases anticipated this regulatory conundrum by increasing their scrutiny of companies' ESG narratives and disclosures well in advance of the legal requirements coming into effect. Investors have shown higher levels of ESG engagement in Europe relative to other regions and already by 2020, regulation has become the top reason for firms deepening and accelerating their engagement with these issues.[3]

Investors have also been one of the strongest advocates for an equivalent legal obligation for investee companies to disclose according to standardised metrics across a broad range of ESG issues. Almost three years after the proposal of the first sustainable finance package, the Commission tabled a revision of the non-Financial Reporting Directive, relabelled the CSRD on 21 April 2021.

The Corporate Sustainability Reporting Directive

The CSDR is in many respects a bracketing or complementary approach to the mandatory disclosure requirements already in effect for EU-licensed asset managers and institutional investors. It would require all large and EU-listed companies (an estimated 49,000 companies) to disclose against a full range of environmental, social and governance (ESG) factors relevant to their business using EU sustainability reporting standards.

While the Commission's proposal still needs to complete the lengthy EU legislative process with negotiations between the Council of the EU and the European Parliament, the Commission has given a parallel mandate for the European Financial Reporting Advisory Group (EFRAG) to draft EU sustainability standards for their endorsement as implementing legislation. The target date for the endorsement of a first set of reporting standards focussed on climate is October 2022.

At the same time, there is strong momentum behind a push for global sustainability standard-setting under the IFRS umbrella, with the creation of an International Sustainability Standards Board (ISSB) expected later this year. The official line on how this relates to the EU standard-setting work is that it is a 'co-creation' or 'building blocks' approach where the

[3] State Street Global Investors report 'Into the mainstream: ESG at the tipping point' November 2019.

international standards provide a baseline or minimum set of requirements but would not prevent regional or national authorities from going further. The degree of overlaps between the standards is also unclear regarding scope; while the EU is aiming to cover a full complement of ESG metrics, the ISSB will be initially focussed on climate while 'also working to meet the needs of investors on other ESG matters.'

The International dimension: The Brussels effect

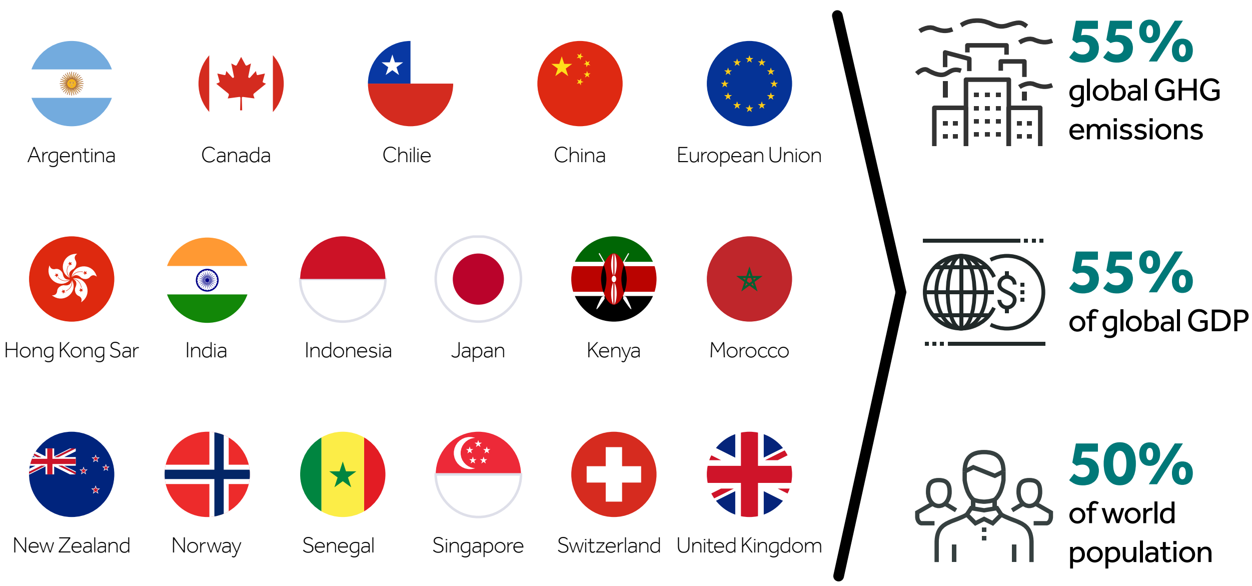
The SFDR and the Taxonomy Regulation became the first statutes in the world to define 'sustainable' economic activity and require mandatory ESG disclosures from a broad swath of the financial sector. Their coming into effect has had strong extraterritorial impacts ('the Brussels effect') under which non-EU companies active in global markets find it beneficial to adopt EU standards throughout their business.

This extraterritorial impact has been further amplified by pressures emanating from the Paris Agreement requirement for more ambitious emissions reductions targets have pushed a large number of other jurisdictions to adopt their own versions of these regulations. As evidenced by the G7 Finance Ministers Communique in June 2021 and the G20 follow up in July 2021, momentum is clearly behind mandatory sustainability reporting requirements and some kind of classification system to redirect capital toward the more sustainable investments needed to reach a net-zero economy by mind-century.

Because the specific pathway to a genuinely low-carbon economy can vary so much depending on social, political, economic and cultural factors, sustainable finance policies will inevitably differ between jurisdictions. The EU experience may influence how the rest of the world moves but it suggests the following approach will continue to dominate:

- disclosure (in particular leveraging the financial sector as first mover) will continue to be the key driver. It is a safe bet that investors will continue to prioritise these disclosures from investee companies in order to fully identify and manage climate-related risks around their portfolios.
- taxonomies or definitions of what is more and less sustainable are unavoidable. Countries will inevitably try to simplify these following the EU's bumpy experience but how these labels are developed and applied will have potentially significant implications for the successful decarbonisation of economies.

Figure 6: Members of the EU's International Platform on Sustainable Finance (IPSF)



Source: IPSF Annual Report 2020

These and other policy tools are currently being considered by numerous multilateral organisations including the G20 Sustainable Finance Working Party, the International Platform on Sustainable Finance, the Basel Committee, the International Financial Reporting Standards (IFRS) Board of Trustees, alongside an equally large number of private sector initiatives. Most, if not all of these organisations, will be releasing reports that cover disclosure and taxonomy rules in the runup to COP26 in early November.

While convergence does seem to be the order of the day on disclosure (at least around TCFD-based requirements), the debate on taxonomies seems headed in a much more fractious direction as jurisdictions struggle with their own legacy fuels and cultural/ political constraints. But both taxonomies and disclosures rules will be are indispensable in making the kind of progress needed to reach ambitious net zero targets and the EU work will continue to influence their development globally going forward.

Next steps

The Commission's latest iteration of their Sustainable Finance Strategy (published July 2021) is testament to the politically challenging and multifaceted nature of the changes needed to re-imagine the low-carbon economy. The taxonomy has had to be adjusted provide more flex to support businesses and citizens through a costly transition. Ever-conscious of the threat such flex might bring to meeting ambitious Co2 reduction targets, the Commission will at the same time accelerate work on a 'brown taxonomy' which would help force financial institutions to better recognise and manage the risks around potentially stranded assets, and incentives for green lending to businesses and consumers.

Finally, on 14 July the Commission tabled a broad raft of real economy regulations (the so-called Fit for 55 package[4]) intended to ensure the broader behavioural changes needed to make the transition possible. These proposals will start to impose real costs (beyond the regulatory burden of the sustainable finance agenda) for those businesses who are not adapting to and investing in the new normal of a low carbon business model.

John Rega
Director, Brussels
jrega@brunswickgroup.com

Carlos Martin Tornero
Associate, London
cmtornero@brunswickgroup.com

[4]This includes proposals for: a Carbon Border Adjustment Mechanism (CBAM), the reform of the EU Emission Trading Scheme (ETS) and revisions to the Renewable Energy Directive, the Energy Taxation Directive, the Effort Sharing Regulation, the Energy Efficiency Directive, the energy performance of Buildings Directive.. and more.

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Brunswick Group
16 Lincoln's Inn Fields
London WC2A 3ED
United Kingdom

+44 (0) 20 7404 5959
londonoffice@brunswickgroup.com

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