EU TAXONOMY AND CSRD

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Sustainable transition, but where to?

The EU's sustainable finance agenda has ruffled some feathers. Fearing to miss the boat on a new area in finance, industry groups from utility companies to heavy industry look for ways to include their business in the sustainable finance agenda under the title of 'transitional activities'. Still, the rationale for this is limited. Rather than increasing the risk of stranded assets by stimulating investments in dead-end technologies, industry groups would do better to advocate an expansion of the taxonomy to the full range of sustainability impacts and objectives.

Our transition to a sustainable economy has a clear end-point: a climate neutral economy by 2050. This means that certain economic activities can, and others cannot fit in the economy of the future. The EU taxonomy gives an overview of the 'green' activities that contribute to the future sustainable economy. By creating an index of activities based on this high standard, the taxonomy helps financial markets and businesses understand where, over time, they need to go. Currently, only a small percentage of our economy fits in the green category. According to Eurosif, only 2.5% of investment funds have a taxonomy-aligned share of their portfolio of 5% or higher. Not being part of this elite section of our economy thus shouldn't be a cause of alarm. That is not, however, how many sectors see it.

Utility companies and EU Member States with a big reliance on polluting energy sources fear to be left behind by the EU's sustainable finance agenda. Feeling unable to rapidly replace their coal-powered electricity with sustainable alternatives, they seek to include gas-powered electricity stations in the taxonomy framework as a 'transitional' category. During negotiations a compromise was reached, allowing for gas only under very specific conditions (see article 10(2)). If no technically or economically feasible alternative is available, activities that are consistent with a 1.5C temperature rise can be taxonomy-compliant as long as they don't lead to a lock-in of investments.

The current focus on transition activities is a dead end.

Given the long lifespan of new gas plants and the need for the energy sector to reach carbon neutrality before our entire economy to reach the 1.5C limit, gas-powered plants simply cannot fulfill these conditions. Continued pressure from industry and Member States has made the Commission commit to a change of the regulation to increase space for transitional activities.

But given the rationale behind the green taxonomy, it is difficult to justify a specific transitional category. The necessary transition is the one from polluting towards green activities. Introducing temporary in-between steps only detracts from this. That does not mean we cannot ensure a broader scope of the taxonomy framework. Efforts to broaden the taxonomy should be directed in two prime areas.

The first direction is to clarify which activities, while not contributing to a sustainable future, do not cause harm to sustainability objectives eithers. Many activities in the services sector, for example, are essential for our future economy and should not be thrown on the same pile as activities that harm our environment. By distinguishing between 'neutral' and 'harmful' activities, investors and companies can more easily identify the activities that can be invested without harm and the ones that require additional attention to ensure they reduce their harmful elements.

The second direction is to add a social sustainability element to the taxonomy. The transition to a sustainable economy will disrupt many lives and we need additional efforts to bring along the most vulnerable in our societies. A social taxonomy can ensure that companies making an active contribution to this area are appropriately rewarded. In July this year, the EU's platform on sustainable finance made a proposal for a social taxonomy based on global standards from the OECD and UN and the EU's Pillar of Social Rights. This provides a good way forward to ensure that more sustainable businesses can be included in the EU's sustainable finance framework.

The current focus on transition activities is a dead end. Investments in such activities will frequently lead to stranded assets and distract from the need to invest in an economy that is truly sustainable. It is better to focus at expanding the taxonomy in different ways. With a full scale of sustainability impacts we can include all economic activities, including those that have a neutral impact on sustainability objectives. With a social taxonomy, we can reward business ensuring the transition to a sustainable economy can rely on sufficient social support. This is the prime way of making the taxonomy a tool to achieve the EU's ambition for a socially and environmentally sustainable economy.

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Sustainable Finance, Taxonomy and CSRD – challenges and opportunities

Over the last couple of years, Sustainable Finance has increasingly left its niche and has undoubtedly reached the mainstream of financial markets. Europe is one of the leading drivers of this development. In 2018, the European Commission laid the groundwork for this progress with the launch of the "Action Plan on Financing Sustainable Growth". In this plan, one of the most urgent challenges identified to enhance the role of E, S and G in financial markets was transparency. This transparency comprises two dimensions.

Firstly, the sustainable investor should have transparency on what he or she is investing in, and whether the desire to invest into sustainable projects and assets is met by the investment strategy of the chosen financial product. This part of the transparency challenge aims at preventing greenwashing of financial instruments.

Secondly, it is evident that in order to enable financial market participants to increase their financing to sustainable projects, transparency over sustainability issues in the real economy requires improvements. Two central instruments to tackle these challenges where envisaged as the development of a taxonomy for environmentally sustainable economic activities and a reform of corporate reporting requirements.

The Taxonomy Regulation was adopted in June 2020. With the recent publication of the first delegated acts, which include the technical screening criteria for the first two environmental objectives – climate change mitigation and adaptation – and the transparency requirements for article 8, the Taxonomy will soon become operational. With its definitions of sustainable economic activities, it sets the targets we need to reach our 2050 environmental goals including climate neutrality. Defining these targets is crucial as it clearly shows where we need to arrive in the long term. However, the Taxonomy in its current form does not as clearly tell us *how* to reach these targets.

Building on improved transparency, right incentives and consistent policy framework are requiered.

The challenge for companies and financial institutions remains to work on feasible solutions and credible transition plans. In the coming years, the transformation towards a more sustainable economy will significantly change our industries. Business models that are profitable today may become unsustainable in the true meaning of the word. Financial institutions play a key role in shifting capital to future-oriented, sustainable business models and engaging with their clients to manage the transition at the speed and scale required. The Taxonomy can serve as a central instrument to manage these risks and opportunities both for the financial and real industry because it can help to navigate the transition. To serve that purpose, the Taxonomy must be easily applicable, benefitting not only the still small share of the dark green segment, but supporting less green sectors and companies to embark on the transition path as well.

Moreover, the Taxonomy will not be the only tool for assessing whether a company is fit for the future. Applying the Taxonomy helps understand which activities of a company are aligned with the EU's environmental objectives. However, it does not provide stakeholders the broader picture of a company's environmental and social performance. The proposed Corporate Sustainability Reporting Directive (CSRD) therefore represents an important amendment to the current reporting requirements. The shift in the terminology from "non-financial" to "sustainability" reporting, as well as its integration in the management report, are important signals reflecting the realization that environmental and social factors can affect a company's position and financial health quite significantly.

A common framework for corporate sustainability reporting that produces relevant, reliable and comparable data on all material aspects of a company's performance is therefore a core element for the shift to sustainable economies. It helps financial institutions to better manage financial risks in their portfolios, identify future-fit sustainable investment opportunities and support their clients and investees in managing the transition. In turn, companies themselves benefit from developing a better understanding of their business risks, opportunities and their competitive position.

However, more transparency by itself will remain insufficient. Once relevant information is available, making effective use of it is the critical next step. The European Single Access Point should make that data easily accessible and connectable to other relevant data sources. Effectively integrating the data also requires revising methods and instruments and – perhaps most importantly – developing new competences and a new mindset. Building on the new awareness, the right incentives and consistent policy frameworks are required, fully aligned with the policy objectives for sustainability, to move from commitments to action.

LAURA
VAN GEEST

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Building on transparency in sustainable finance

A swift and global response is needed to reduce greenhouse gas emissions and to make our economies sustainable. The EU is well placed to take a leadership role in developing and implementing various initiatives, not least when it comes to promoting sustainable finance. The EU Green Deal leads to a better pricing of Co_2 emissions and the Sustainable Finance Strategy – including legislation such as the Taxonomy Regulation, the Sustainable Finance Disclosure Regulation (SFDR) and the proposed Corporate Sustainability Reporting Directive (CSRD) – is a necessary complement. At present, no other major economic block can match the EU's drive towards sustainable finance in terms of ambition and political commitment.

Crucial elements in fostering the transition - investor consciousness and consumers' desire for sustainable products - are fortunately experiencing an upswing. However, a lack of transparency on sustainability risks and impact of corporate activities, as well as the risk of greenwashing, constitute serious barriers. The EU Taxonomy, CSRD and SFDR are designed to tackle these problems. It is crucial that their requirements are appropriately implemented by Europe's corporations and financials.

Together, the Taxonomy, CSRD and SFDR cover much of the sustainability reporting chain – from corporations, to financial market participants, to end investors. While the Taxonomy provides necessary guidance and definitions on what activities count as (ecologically) sustainable, the CSRD will require corporations to report (among other things) to what extent their activities are Taxonomy-aligned, which in turn provides valuable input for the sustainability-related disclosures of financial market participants as required by the SFDR.

While the existing legislation and legislative proposals cover much of the sustainability reporting chain, important challenges remain. Corporations and financial market participants are confronted with the major task of collecting adequate data on sustainability, in an economy based on complex globalised supply chains.

There is an important task ahead for legislators and regulators to facilitate and guide industry efforts to address these challenges, in a way that is consistent across the EU. The AFM, for its part, is actively involved in the development of enforceable standards and works closely together at the EU level with aim of achieving a single rulebook and a level playing field.

The AFM encourages the EU and global standard setters to ensure their initiatives are compatible.

Reliable sustainability benchmarks and reliable provision of ESG data-related services, are key ingredients in overcoming transparency challenges throughout the value chain. For this reason, the AFM and the French AMF have jointly published a position paper advocating a European regulation for the provision of ESG ratings, data and related services[1]. Adequate, reliable and comparable data are essential for companies and investors to be able to make sustainable investment decisions and combat the risks associated with greenwashing.

However, cooperation and coordination in fostering a sustainable economy should not be confined to the European level but needs to extend globally. Investors are working on a global basis. Thus, it is important that issuers apply global standards. Active and ongoing engagement and alignment between European (e.g. EFRAG) and global standard setting bodies (e.g. IFRS Foundation and IOSCO), as well as legislators and regulators is therefore of the utmost importance.

The AFM fully supports the European initiatives in the area of sustainable finance. The EU Taxonomy, CSRD and SFDR are currently the most ambitious and far-reaching efforts on a global scale and therefore are well-placed to serve as inspiration for setting in motion the transition towards a sustainable economy. Aligning European standards with global sustainability standards, for which the European initiatives may serve as inspiration and building blocks, will ensure a level-playing field between European and non-European companies, investors and consumers. This is a necessity in today's global financial markets. Agreeing on global standards will have the added advantage of limiting administrative burdens for cross-border business and financial flows.

Despite important efforts much work is still to be done, and to be done fast given the imminent environmental crisis the world is facing. Formulating ambitious objectives, setting corresponding global sustainability standards and making sure information is accessible, transparent and comparable is crucial for legislators, regulators, industry and investors to join hands in the imperative transition towards a sustainable economy.

[1] *AMF & AFM, Call for a European Regulation for the provision of ESG data, ratings, and related services*, 15 December 2020, French and Dutch financial market authorities call for a European regulation of ESG data, ratings, and related services | AFM.

NATALIE WESTERBARKEY

Director & Head of EU Public Policy, Fidelity International

Disclosure policy will unleash the full potential of sustainable finance

The EU taxonomy and CSRD are key drivers to speed up the transition towards sustainable economic models. The European Union is pioneering policy efforts internationally and other regions are increasing efforts too, most notably China and a re-engaged USA. This is in the interest of European stakeholders, as global regulatory convergence of ESG policies will foster transparency and investor knowledge in sustainable finance. Companies and investors with in-depth knowledge of ESG policies will be able to unleash the full breadth and depth of financial opportunities it presents. Fidelity's Sustainable Investing Report from July 2021 provides a variety of examples and reveals how we are taking specific action on behalf of our clients and society.

The CSRD and the new EU sustainability reporting standards (EU-SRS) will have a substantial impact from an asset management perspective. The fact that the recently extended scope includes large companies and corporates listed on stock exchanges is expected to result in much greater transparency of ESG factors. As a result, asset managers will be better able to integrate these factors into the investment process in a more detailed and comprehensive way. Another improvement is the proposed audit or assurance requirement on the reported information by corporates as it represents an external, independent validation. Consequently, this new requirement will likely lead to greater accuracy and standardisation of the reported information, hence make the ESG data more comparable across investee companies.

Due to enhanced data availability there is furthermore increasing statistical evidence of a positive correlation between financial and non-financial performance. This conviction is now commonly acknowledged within the asset management and investor community. It is furthermore measurable not only for climate related factors, but also for social and governance factors. Consequently, it is a significant step that the CSRD reporting requirement includes not only corporates' climate related data, but ESG data more widely, including social and governance elements too.

Only global standards can ensure a meaningful and comparable disclosure.

Furthermore, the EU policy approach of dual materiality is strongly supported by the asset management industry : the assessment of financial materially with regards to company valuations must include both, the value impact of climate and ESG factors on the company and vice-versa. At the international level, it is therefore important that the TCFD reviews its current single materiality approach with regards to climate-related financial disclosure only, and reconsiders a dual materiality approach as foreseen also within the internationally applicable TNFD, the nature-related financial disclosure.

Hence - as a next urgent step - working towards globally consistent standards is essential for the efficient integration of commonly acknowledged ESG factors into the investment process, as capital markets are global and to prevent potential regulatory arbitrage. Most importantly, global convergence is key to guide the understanding and sustainable finance choices which are ultimately taken by the end investor.

The ESAP - European Single Access Point - is a welcome tool to help asset managers and investors navigate the magnitude and complexity of the ESG data challenge. The ESAP is expected to deliver greater corporate transparency and comparability, which are indispensable to ensure a robust investment process.

Beyond data, Fidelity takes an active asset management approach through stewardship and corporate engagement. Also, through our updated voting policy we directly incentivise investee companies to embrace a transition to net zero and continuously support the improvement of their overall ESG performance. This results in enhanced financial and non-financial performance, making investee companies more robust and consequently meets our fiduciary mandate vis-à-vis our clients' capital that we manage on their behalf. Fidelity's ESG Analyst Survey from June 2021 reveals some key ESG trends that have largely gone under the radar, which analysts discovered through active engagement with corporates.

The key challenge for asset managers is the time sequence of the regulations' entry into force applicable to the finance sector and corporates. The SFDR (Sustainable Finance Disclosure Regulation) requires asset managers to disclose sustainability data is applicable already since March 2021. Whereas the CSRD, which mandates corporate disclosure becomes applicable only from 2024 for the financial year 2023. Active asset managers can overcome this challenge through direct corporate engagement, collecting and validating data from companies directly. However, only common global regulatory standards are essential for corporates and asset managers to ensure a meaningful, comparable disclosure approach, so to unleash the full potential of sustainable finance.

FREDRIK EKSTRÖM

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Inclusion and transition – Let's realize the opportunities

At Nasdaq, we keep taking initiatives and develop offerings in order to support listed companies within ESG. Nasdaq is also in continuous dialogue with investors and other industry stakeholders around us to seek out new ways to support the investment community in its sustainability efforts. Our ESG Guidelines first introduced in the Nordics are now in place on our markets globally, as well as our ESG Data Portal and Sustainable Bond Network. Another example is the recent acquisition of Puro.earth, a global marketplace for carbon removal, a business which we aim to scale in order to address a growing demand for carbon removal around the globe.

Companies are changing behaviors and new business ideas to support the transition are emerging. All this needs financing, and EU regulatory initiatives have great potential to play a central role for transition to a more sustainable society.

Extending the Taxonomy to transitional activities will be very welcome. This will help companies provide clarity towards investors on what transitional activities need to be financed. Bonds are a very suitable instrument for financing transition. In Nasdaq's Nordic markets, the Sustainable bond issuances already represent ~30% of all corporate bond issuances, and they are often significantly oversubscribed. It illustrates the strong demand from the investor side to contribute to financing of sustainability. In this context I want to highlight the not yet realized potential of bond financing in general, and green bond financing in particular, for smaller growth companies and for smaller investors. Today, the wholesale bond markets have developed. Issuers and other stakeholders in the financial ecosystem tend to stay only in the wholesale segment, due to both the structure of the market and due to regulatory incentives in the Prospectus Regulation.

I see an opportunity in revisiting the threshold in the Prospectus Regulation, to facilitate a development of a market for bonds with lower denominations. This would open up opportunities for smaller investors as well as smaller growth companies.

CSRD needs to support more efficient capital allocation to more inclusive and sustainable growth.

Based on the ongoing development of the Taxonomy we are already offering Green Designation of our equity market. Especially in the real estate sector this is developing. In general, I foresee that the Taxonomy will be the key regulatory instrument and I reiterate that the extension to transitional activities should be prioritized.

The expected development of a social taxonomy is also welcome. The social aspects are necessary not only in the longer term but also in the shorter term for the recovery from the effects of the pandemic. Nasdaq's engagement for diversity and inclusion is manifested in many ways in the societies where we operate, in Europe, in the U.S. and beyond.

I also welcome the review of the Non-Financial Reporting Directive, as it responds to a need among both corporates and investors to be better aligned around sustainability reporting. Ultimately, **CSRD needs to support more efficient capital allocation to more inclusive and sustainable growth**.

The biggest opportunity with the CSRD is to provide European companies with one single reporting standard instead of several. This will provide clarity for both companies, investors and any user of sustainability reports. If the EU standard can build on already developed standards, that's most useful, and if there can be convergence beyond the EU, even better.

Another opportunity is to provide a framework appropriately adapted for SMEs, supporting as many companies as possible to get onboard. From my experience working with the many growth companies that opt for public financing across our markets in Europe, I know that every company wants to be part of the transition towards a more sustainable future.

Nasdaq has since long provided support, services and products tailored to growth companies. We know the transition cannot be done exactly the same by every company, but every company is taking steps. In order to maintain as many options as possible open for financing for growth companies, we propose to subject all SMEs to the same rules on sustainability, irrespective of financing mix. Drawing the line as regards the scope of CSRD between companies with equity financing on public markets on the one hand, and companies financed with for instance bank loans or private equity on the other hand, is artificial.

Drawing up an appropriate sustainability reporting standard for SMEs and making them voluntary for all, I believe, is the best way forward for supporting the most companies on the route towards sustainability while at the same time not raising additional barriers to financing on public markets.

RICHARD MATTISON
Chief Executive Officer,
S&P Global

Tackling the data challenges behind the EU sustainable finance agenda

The EU is in the vanguard of mainstreaming sustainable finance. Both the EU Green Deal and the Sustainable Finance agenda have set ambitious objectives to reshape the economy and channel capital towards sustainable investments. However, significant gaps exist in the data needed to inform investment decisions during this transition. Tackling this data challenge in the EU through enhanced corporate disclosure standards, international compatibility, and by leveraging technology can provide momentum for global solutions.

The data on climate change makes for uncomfortable reading. According to S&P Global's latest research, a 72% reduction in emissions is required to achieve the goals of the Paris Agreement. Major companies are currently on track for a >3°C global warming scenario. 80% of major global companies will face moderate physical risk due to climate change by 2050. We estimate that under a strong global policy framework these companies will face $284 billion in carbon pricing costs in 2025, 13% of their earnings, and this cost would rise significantly over time.

This is why disclosure matters: it can expose risks for companies, industries, and markets. By identifying and measuring these risks financial markets and companies can start to address them. Better and more meaningful ESG data from companies will enable issuers and users of corporate disclosure to identify, compare, and act upon emerging risks and opportunities. The EU's approach to disclosure in the CSRD also applies double materiality providing vital insight on how economic activities impact our planet.

The main challenges when trying to evaluate ESG and climate risks for individual corporates are the lack of disclosure generally and – where disclosure does exist – the lack of comparability across peers. The EU Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR), and the Corporate Sustainability Reporting Directive (CSRD) are setting new standards in this space.

However, navigating these new regulations will be a complex endeavour. Ensuring that they remain aligned will be vital. Without an efficient system to produce, channel, and analyse ESG data investors and companies could miss out on critical insights and risks. High quality sustainability reporting should be the goal to enable evidence-based decisions.

S&P Global believes that it is important for corporate disclosure to be comparable, reliable, regular, relevant, and accessible.

As a user, aggregator, and provider of sustainability related information, S&P Global believes that it is important for corporate disclosure to be comparable, reliable, regular, relevant, and accessible. In 2020, S&P Global's Corporate Sustainability Assessment included 7,032 companies, up from 4,200 the previous year. In 2021, we will be collecting ESG disclosure from 10,000 companies globally. On climate we have over 700bn data points and have extensive analysis of climate risks for over 110,000 companies on the physical impacts of climate change. Comparability and standardisation of ESG and climate data remains one of the most important challenges for the financial system if we are to allocate capital to addressing sustainability related risks.

Dialogue and coordination at international level is essential to ensure positive steps on ESG remain aligned with global market practices and regulatory frameworks. As momentum builds behind a global set of internationally recognized sustainability reporting standards connectivity and comparability across jurisdictions will also be key. The work to establish an International Sustainability Standards Board (ISSB) under the IFRS Foundation should be seen as complimentary to the EU's CSRD. The primary focus of both initiatives should be on the integration, enhancement, and alignment of existing sustainability standards rather than the development of completely new ones.

The ability to leverage technology as this new data system is built represents a significant opportunity. The CSRD proposal would represent a significant leap forward in its requirement for disclosure to be provided in digital format. In 2015, S&P Global's Corporate Sustainability Assessment created an XBRL taxonomy in order to align with other taxonomies and company-produced reports. However, the creation of XBRL taxonomies or adoption of this reporting by companies has been slow. More standardized reporting formats coupled with more standardized factors will play a significant role in driving better disclosure by companies and adoption of ESG information by investors.

At S&P Global we have developed data sets, analytics and, solutions to meet the changing regulatory requirements and increasing market demand for high quality sustainability information. We believe that enhanced corporate disclosure standards, international compatibility, and leveraging technology are key components of tackling the data challenge in the EU and globally.