EU TAXONOMY AND CSRD: POLICY TRENDS AND IMPLEMENTATION CHALLENGES

1. Taxonomy and the CSRD aim to provide reliable and comparable knowledge of the sustainability of companies and daily processes of the financial sector as the progress of economies is too slow

An industry representative stated that much has been invested in understanding sustainability data. The evolution is wonderful, but this is a 'code red' situation for humanity. Risks are rising rapidly and in a non-linear fashion. Around 77% of global companies, or the top 12,000, publicly report carbon targets, which is good, but those targets show a 72% shortfall against the Paris Agreement. There is commitment, but a huge shortfall. 66% of companies face high risks from the impact of climate change, according to S&P analysis of 3 million assets owned by 110,000 companies. Greater transparency on risk and opportunity is needed to understand how companies are transitioning and adapting to climate change, which is critical to S&P's work to serve the market with sustainability intelligence of the highest quality that enable investment decision making and enable capital to flow towards sustainable outcomes.

An official stated that progress is still too slow considering the magnitude of the challenge being faced and that time is running out. This decade will be decisive in answering whether climate change can be limited, and the transition of the economy managed quickly and as needed. A key challenge to overcome for the transition is in finding the right levers to pull. Financial markets can play a key role if there is reliable, comparable, and good-quality knowledge of sustainability aspects at a company level.

The taxonomy and the Corporate Sustainability Reporting Directive (CSRD) aim to increase knowledge and are complementary. The taxonomy will only work if information on firms is in place and so good results are needed on CSRD. Germany is happy to contribute at the European level and supports double materiality for CSRD reporting that shows how sustainability, risk and opportunities affect companies' business models and their impact on the environment and human rights. A credible and practicable taxonomy is required. The financial industry, the real economy, and small and medium-sized enterprises (SMEs) must make use of the taxonomy and the data and deliver high-quality data. A practical approach from market participants to use taxonomy and CSRD to make the transition possible is key.

Once frameworks are in place and the relevant information is available, it must be integrated in daily decision-making. Financial institutions can use it to better manage financial risk in their portfolios, identify sustainable investment opportunities and support clients and investees in managing the transition. The financial sector's role is critical to help the industry and SMEs to manage this. Companies will benefit from a better understanding of business risk, opportunities, and competitors' positions. Regulations, the taxonomy and the CSRD are essential to manage the transition. The Chair (Sébastien Raspiller) highlighted the key term 'double materiality.' There is no point in collecting data that is not linked to the goal of carbon neutrality by 2050.

2. Nuclear energy, financial sector remuneration schemes, transition acceleration, a more inclusive transition, and helping investors to identify whether a financial product is green or not are some of the remaining policy challenges faced by the EU sustainable finance framework and taxonomy

A public representative stated that the taxonomy and the non-financial reporting directive (NFRD) is needed as the taxonomy shows where to go and how activities fit into a sustainable society and economy, while the disclosure regulation and the CSRD show who went there. It is a work in progress and the proposal is far from perfect. Work started in 2018 knowing that the order of the legislation was not logical and that it would be incomplete to start with, but these are vital building blocks to make the financial sector sustainable and to contribute to a sustainable economy and society. It was not easy and there was much discussion of the regulatory technical standards (RTS) and the delegated acts. Nuclear energy is on the table. Some member states think it is good, but this is toxic and could potentially lead to a 'meltdown' of the taxonomy. When there is discussion, it is relevant, and that is good.

The public representative stated that it is about building blocks, but movement is needed. It is not only the regulatory setting of the financial markets and financial markets participants that is important. Markets need to be clear that they serve people and the planet, as this provides their licence to operate. It should be reflected in financial market participants' internal organisation, and it is vital to look at remuneration policies because, if they are still in financial terms, it shows the business is not serious about sustainability even though it has sustainability reporting. If a CEO is still remunerated only in shares, it is not likely that the company is sustainable.

Environmental, social and corporate governance (ESG) work needs to expand its focus from the E and, within that, climate change, to the S regarding energy challenges. The transformation must be inclusive. If it is not, it will be a bumpy road and the building blocks will not be as effective as they should be. Not everything is about data. Data is important for standardisation, but not all risks or adverse impacts can be captured. Risks from issues like child labour, forced labour or land grabbing cannot be standardised. It does not mean the risk is not real. The aim is to serve people and the planet and make profit to arrive at that.

An industry representative noted that there is a great deal of talk about environmental data and that is critical, but there is also a need for inclusion and diversity. There are more aspects of the issue than just the environment. It is important for society and for economic growth that it becomes more inclusive.

An official agreed it is important that the financial sector gets reliable information from the real economy and corporates. There must be regulations and requirements to make it easier for clients to identify whether a financial product is green. Guidelines or something from ESMA or other European bodies are needed for a level playing field, particularly regarding the directive on undertakings for collective investment in transferable securities (UCITS) and other products for retail investors. There is still some work ahead.

An industry representative commented that, from a policy perspective, internationally commonly agreed convergence and investor education are key so that end investors understand easily what is and is not sustainable and can mandate asset managers to invest on their behalf into sustainable companies. It also needs to be guided by policies. Asset managers and investors depend on simple and transparent policies, but this is driven by the end investor community and investor education, to make them aware that their capital can have an impact. That is key to unlocking the sustainable finance agenda.

An industry representative stated that insurers need help. Outcomes should be as simple as possible when reporting to financial markets and clients. Good advice and dialogue on an investment's evolution must be accessible to all, including those without high-level financial or environmental education. Comments about data collection sequencing are positive, as the financial sector had to wait for data from corporates to give high-quality reporting. Adapting work processes is also supported.

An industry representative stated that making change requires supporting change and there is an opportunity to create a framework in the taxonomy around transition. An example is the sustainable bond market and its support for raising capital used to transition. The new standard for EU green bonds, linked to the taxonomy, can create a framework for transition, and help achieve targets within the sustainability finance policy.

An industry representative stated that CNP is among the European market leaders for personal insurance and is in favour of the Commission, governments, and the Parliament's efforts to help, as the concerns are felt deeply. CNP promotes sustainable investment, sustainable economies, and social organisation. Around €350 billion of reserves is managed, so sound and clear criteria are required to guide in channelling investments where they can be useful to the transition. Insurers are concerned by risks related to climate change or social challenges and underwriters must integrate it all, so criteria that can help is good. Clients are advised on investments and so sharing their dedication and willingness for new products related to environmental protection and the transition is essential. The work in progress is welcome.

Common standards are required, and it would be good if they were global. Wide coverage of this set of indicators is needed, not only on the environmental, but on all aspects of ESG. It would be good to cover not only dark green potential investments, but to be guided in the election of dark or light green, white or black products or corporates, to nuance the evolution of existing reserves and assist insurers that are invested in sovereign bonds and fixed income. Taxonomy about sovereign bonds would help, and the wider they are the better.

A regulator stated that transparency and sustainability are important for investors but will not bring about climate transition alone. Fair carbon pricing mechanisms and other measures are needed.

3. Addressing the fragmented non-financial reporting landscape and unlevel playing field, and closing the data gap, require a clear and robust set of rules and sustainability reporting standards

An official emphasised the availability of quality ESG or sustainability data and reporting. No policy or strategy can be successful without quality data, which means relevance, faithful representation, comparability, verifiability, and auditability. The 2014 NFRD and subsequent guidelines were innovative but insufficient to create a comprehensive and quality data landscape, so a costly multiplication of individual efforts and of private initiatives exists. It is fragmented. There is an emphasis on ambitious public policies. A public representative raised the focus on sustainability objectives and that there is a need to move forward on the quality of sustainability data and reporting. The CSRD was proposed by the Commission in April and is following the legislative process. The CSRD intends to create a mandatory environment of sustainability reporting based upon providing a clear and robust set of principles and rules to apply and innovative sustainability reporting standards. The Commissioner and Executive Vice-President Dombrovskis stated 18 months ago that it would be impossible to move forward without standards and proposed that non-financial reporting should be on a level playing field with financial reporting.

Standards are progressing and the EU is in a front-running position. At the Commission's request, EFRAG launched a taskforce a year ago. The first phase was preparatory work, as it is a dense report. When the legislative proposal was tabled, the Commission requested EFRAG start elaborating standards and that a prototype will soon be available, which is an element of a global set of standards, on the basis of a working paper on climate. It is ambitious and there will be much discussion before it is finalised. The goal is to deliver standards by June 2022 to allow for implementation by reporting entities in 2024 with 2023 as a reference.

4. As SMEs play a key role in growing the economy and creating jobs, they should comply with the same rule framework as larger ones based on a simpler framework after a compliance period

An industry representative stated that the taxonomy and the CSRD are welcomed to help clarify which critical ESG and sustainable data points need to be disclosed. That will help investors compare information efficiently. The multiple reporting standards for corporates can be harmonised. Two important areas are implementation and developing an effective sustainable finance policy for corporates, focusing on SMEs, and transition. Many growth companies have come to Europe's public market in recent years. Small start-ups that raise capital in the public market grow into larger companies and create economic growth and jobs. Many of these are on board with sustainability or have sustainability as a core business model.

SMEs should be subject to the same rules of sustainability disclosure, irrespective of their financing mix, as for large companies. Smaller companies cannot comply with the same rule framework as large ones, so the proposal that SMEs should have a simpler framework and an extended period for compliance is positive. This special standard for SMEs is important and must be truly adopted, as SMEs play an important role in growing the economy and creating jobs. It also links these regulations and Capital Markets Union (CMU).

The Chair noted that there is a question of why listed or unlisted would have an impact on reporting when talking about going green. The call for proportionality and the specifics on it is also understood.

5. Investors demand accelerating transition so asset managers strengthen processes and capabilities for a better systematic engagement on ESG with companies

An industry representative commented that the biggest challenge for the asset management industry is sequencing. Asset managers must comply with the Sustainable Finance Disclosure Regulation (SFDR) from March 2021. However, the corporates invested in will only have to comply with the revised version of the NFRD that is deeper and wider in scope on ESG data from 2024 onwards. Asset managers are asked to disclose data that is not yet available from the corporates. Fidelity International is an active asset manager and is overcoming this through engagement with companies that are invested in and assessment of their published sustainability reports. ESG ratings from rating agencies are analysed. An internal analyst investment capability engages with the management of companies invested in directly to validate the data and assess its quality. An ESG propriety rating tool was developed which gives managers' assessment on how the corporates are doing on ESG and how they benchmark with each other. There are two benefits of this. The data assists corporates in improving sustainable performance and incentivises them to become greener and more aware of their social impact. If it succeeds, then investments will have an impact. The engagement fulfils fiduciary duties to investor clients as the stewardship role means acting on clients' behalf to ensure that investment is made into sustainable corporates and sectors. The end investor gives the mandate, and they have a choice of investing sustainably or not.

A regulator noted that the supervisory view is that CSRD and the taxonomy will enable transparent, relevant, and comparable reporting on corporates' sustainability. This helps investors and financial institutions to assess firms' sustainability risks and enables a better risk-return assessment, and this applies whether it is brown or green. It also provides information to those who want to direct firms to sustainable sectors and transitional activities. It also helps protect investors against greenwashing. Clear labels help retail investors not to be fooled and assist corporate management with reporting. It makes them more likely to move towards a sustainable way of working. It will enable more dialogue or engagement, as Natalie Westerbarkey commented, not only in the private sector, but also in public debate.

An industry representative hoped that policymakers progress the agenda quickly under the Slovenian Presidency in Ljubljana, the French Presidency in 2022 and the Czech Presidency in the second half. It is pace over perfection. Everything in the industry's power must be done to the best of its ability to implement a sustainable agenda and not wait until policies are finalised. The race to net zero is on.

6. Data to clarify near-term impacts on business models, non-financial information comparability, the consistency of information and the applied scenarios are challenging at EU and global levels

An industry representative stated that issues of consistency, comparability and relevance are widespread and there are huge information gaps and data holes in the marketplace. Companies report well, but often not in a comparable way, and beyond the top 5,000 companies reporting drops sharply. The Commission's efforts in the taxonomy and the CSRD are welcome, as they help to plug some of the gaps and ensure consistency in information flow. There is a need to translate the non-financial into the financial. Double materiality is important, but there is a link between the two and, whether it is long-term or short-term, financial impacts must be understood in financial terms. Electronic tagging is also welcome. A critical component of the CSRD's success is that if information is electronically tagged by companies at source, it democratises the information flow for capital markets and reduces the burden for companies. While there may be upfront costs in electronically tagging disclosure, it should reduce companies' burden as they face less questionnaires from multiple organisations. The evolution of the taxonomy and the CSRD is anticipated.

The financial sector can be part of the solution, with 70 trillion of assets signed up to the Glasgow Financial Alliance for net zero, so a significant commitment. The problem is the information gap. There are many long-term commitments, but not much evidence of how to transition to 2025. This is unusual for markets. Normally there is a great deal of near-term information, and not many 2050 revenue forecasts. Here, it is the opposite, with many long-term commitments, but not as much on the level of business model transformation required to reach a meaningful change in sustainability characteristics by 2025 or 2030. The question is how to address that. The CSRD and the taxonomy will help, as an issue for financial institutions is good-quality information to develop plans and targets and transform business models. Without that, decisions are made without the requisite evidence. One issue is the information gap in private companies. A private equity investor or bank needs a great deal of information from private companies, and not much is flowing now. Other gaps have been identified, particularly on forward-looking information and the consistency of climate change scenarios. Long-term commitments need to be supported by near-term plans; the taxonomy and the CSRD will help, but a great deal of disclosure from companies will be needed to get things moving faster.

An industry representative agreed there is a data issue for corporates and investors. The regulation is an opportunity to align and clarify critical data points. Local data is available and harmonising it to make it more relevant is an important task. A public representative (Paul Tang) stated that work needs to be done and is being done. There is a question, from being at Eurofi and talking to asset managers and institutional investors, of why it is not possible to share more data. Perhaps data has the character of public good and so there is not enough cooperation among market participants to share data and make progress.

7. As portfolios are global, comparability between EU and non-EU data sets is essential

A regulator commented that, with these directives, the EU plays a leading role in bringing about transparency and comparability. Sustainability is not a local or European issue. It is a worldwide issue, as investment portfolios are often global and comparability between EU and non-EU corporations and investments is essential. The IFRS's work on this is welcome. The EU should not slow down but it is good to have this work in coordination. Coordination is challenging, but aligned standards are vital, and one standard or comparable global standards should be the aim. The AFM supports the high ambitions of the CSRD and also the focus on double materiality. This can be instead of the single materiality of the IFRS, but a way to progress would be to have international standards as a building block with additional EU requirements on top, so something that is comparable and then the European topping up.

An industry representative agreed about dual materiality as the company's impact on the climate and the climate on the company are financially material. Acting quickly and in concert is key. An official stated that EU standard setting does not operate in isolation and there is a goal of co-construction at international level. Not all jurisdictions are on the same page, so a baseline is considered. Meetings are being held with the IFRS foundation and it is hoped that this will develop. A public representative noted that dichotomies still exist between European and global standards, but global standards are welcome if they embrace double materiality. This will be a dichotomy for some time.

8. Rating agencies fill a crucial gap in the availability of sustainability information. However, there is reduced transparency on their data processing and rating methodologies, and ESG ratings can differ

A regulator (Laura van Geest) stated that the SFDR, the CSRD and the taxonomy are progress towards creating a framework for effective transparency on sustainability matters. This has been done in the wrong order, as is clear from asset managers that have implemented SFDR in the Netherlands. Even if this is a good framework, the ESG data and the rating agencies' part is still lacking. They fill a crucial gap when corporations do not have sustainability information readily available both within the EU and outside it.

There are questions of why they need to be regulated and why also by French colleagues. It is not that regulators like to regulate whatever moves, but because there are potential conflicts of interest within organisations that sell data and provide data ratings. Regulators are concerned about the lack of transparency on data processing and rating methodologies and that ESG ratings from one company to another can differ widely even on the same topic. The ESG reporting chain will only lead to transparency and comparability if all links in the chain are strong.

9. Implementing new reporting requirements, defining new investment products and embedding sustainability in internal decision-making processes is complex and costly

An industry representative noted that it is good to be in touch with the building of these regulations and to exchange how it is on the ground. The impact of new reporting requirements is significant, but manageable, partly as insurers have been asked for so many supplementary reports in the last decade that they can adapt processes to new requirements. However, if it is manageable, it also has a cost. As an example, information documents have to be adapted to clients. CNP has 50 million clients and so the annual overall document costs around €10 million a year. If that is multiplied by the number of documents that have to be sent, it is something material. It will not change financial results and there have been no problems in the market because of it. Conditions exist to take it the right way, which already happens in corporates and companies, and decision-making processes are being modified in a number of areas. The first to be impacted is the investment decision-making process. Insurers are used to assessing levels of risk and to choosing investment by arbitration between levels of risk and return and diversification.

There is a new set of standards and criteria. Teams in investment committees are appraising investment projects through the taxonomy. It is already real in companies and that is true also in marketing. Often when colleagues propose new products, especially for unit-linked retained investment products, they include the green key in the product. It is a key feature, and a new product would not be issued without several options which can be presented to customers as compliant with the taxonomy, so there are requirements. It also has an impact and is important in risk assessment processes and procedures. Last year France had the first stress test linked to environmental criteria. The environment of the risk is not fully considered, but this is new, and it is happening. Things are being implemented at some cost. It is a supplementary burden of reporting, so while insurers are not keen on more requirements for reporting, it is being processed without major difficulties. The most difficult part will be the quality of the data coming from the corporates.

An official stated that the gap will be reduced if the CSRD is fully adopted and if the standard setter does a good job. Instead of being confronted with multiple initiatives with huge, related costs, it is vital to simplify. A mandatory environment based on robust standards is one solution.

10. Avoiding greenwashing, keeping trust and further clarifying transition pathways and final targets are key success factors

The Chair agreed that it is key to avoid greenwashing and to keep trust. The journey has many building blocks. It is key to also find ways to educate the average person. Data reporting should serve a purpose but is not there yet. More technical and academic work is also needed. It is not only about data; it is also about developing technologies, including ones to measure adequately.

There is a strong political commitment to carbon neutrality by 2050 and there should be a way to be sure of measuring whether this has been achieved or not, as that will be asked by every citizen in the coming years.