SFDR / CSRD / TAXONOMY USABILITY CHALLENGES AND IMPACTS

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Fine-tuning needed to ensure investors contribute to the European Green Deal

There is no question that urgent action is required to address climate change and that environmental protection should be integrated into economic growth strategies. In the financial sector, insurance and pension funds have the longest investment time horizons and hence the greatest stake in sustainability. It is also necessary to ensure that retail investors can invest and save sustainably, and participate in the transition to a greener economy.

EIOPA believes that the policy framework put in place is sensible to achieve these goals. The Corporate Sustainability Reporting Directive (CSRD) establishes reporting requirements for issuers, the Sustainable Finance Disclosure Regulation (SFDR) establishes disclosure requirements for financial market participants. In addition, the Insurance Distribution Directive (IDD) requires advisers to integrate sustainability preferences as part of the suitability assessment and there are other initiatives at play, such as EU Ecolabel and Green Bonds. The EU Taxonomy provides common definitions for those economic activities that can be considered environmentally sustainable – the basic language to communicate information on sustainability.

Yet sustainable investing – and reporting – is a complex and sometimes challenging path to navigate.

Insurers, insurance intermediaries and pension funds are required to disclose principal adverse impacts of their investments under the SFDR. They are also required to provide details of the objectives of the products and pension schemes that they make available.

Data is one of the critical factors. In particular, corporate data is crucial to ensure that insurers, pension funds and other financial market participants can screen their investments and report on social and environmental indicators, including the principle adverse impact indicators. However, one difficulty for the insurance sector is that the deadlines for disclosure for insurers precede the deadlines for reporting of company-reported data. EIOPA considers it essential insurers already start with disclosing responsibly, despite the challenges in doing so in the absence of the CSDR being in force.

This pragmatic approach allows insurers to make a serious best effort, while supervisors monitor this effort and the progress made in the first year of the SFDR, while recognising the existing limitations.

Besides insurers, retail investors also face challenges. Most sustainability-related products currently being sold fall under Article 8 of the SFDR – 'a Fund which promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.' This is a broad definition and consumers may not always be aware that this category covers products with a low sustainability ambition. For consumers seeking a product with a high level of ambition, they might not find anything suitable within the current market offer.

And while there is a need for more information, there is also the potential for information overload. Will consumers really read the soon-to-be seven pages of information on sustainability that comes on top of the basic disclosure on the product? The volume of information is one element, but there is also the complexity. Will consumers understand the technical terms? When seeking advice, will they be able to answer questions from advisors on sustainability preferences?

EIOPA is working to address these issues. For example, when it comes to preferences, EIOPA recently published guidance on integrating the customer's sustainability preferences in the suitability assessment under the IDD. The guidance includes how to help customers better understand the concept of 'sustainability preferences' and their investment choices; how to collect information on sustainability preferences; and how to match customer preferences with products, based on product disclosures under the SFDR.

With regard to the Corporate Sustainability Reporting Directive (CSRD), EIOPA welcomes the political agreement reached by the co-legislators. Companies need to know to what extent they are responsible for climate change and other sustainability impacts, as well as identify the costs for them that result from sustainability changes. Overall, increased transparency in sustainability reporting from companies is needed to more effectively promote investor protection and combat greenwashing. Increased transparency will also help to detect ESG-related risks which may undermine financial stability and to support the EU's ambition to enact an effective transition towards a more sustainable economic and financial system.

EIOPA recognises the challenges that financial market participants and retail investors face with sustainable investing and reporting. But greening the economy is non-negotiable and EIOPA will make every effort to support the insurance and occupational pensions sectors in achieving this goal.

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Sustainability reporting: moving forward, but not plain sailing

Several years have gone by since the conversation about sustainable finance started. Throughout this time, Europe has strongly supported the transition to a more sustainable economy and has been at the forefront of efforts to build a financial system that supports sustainable growth.

Looking back, it is impressive how much we have advanced in the development of a new sustainable finance regulation. One of the main drivers of this change has been the establishment of a transparency framework based on disclosures at product and entity level in the financial sector.

Firstly, the EU-wide classification system introduced by the Taxonomy Regulation has provided clarity for investors on environmentally sustainable economic activities. Additionally, the Sustainable Finance Disclosure Regulation (SFDR) has implied a great change for asset managers and asset owners setting disclosure obligations of an entity's investment decisions and requirements on how to present the characteristics of products. Lastly, the Corporate Sustainability Reporting Directive (CSRD) will be a game changer in enhancing comparability and increasing transparency on sustainability corporate performance.

However, despite all the effort made so far, the challenges ahead are still huge, partly due to the intensity and velocity of this regulatory wave. These changes will take time to digest. I would like to underline three of these challenges: risk of greenwashing, a lack of criteria for market participants and regulators, and possible inconsistencies across regulatory requirements.

First, greenwashing. One of the main objectives of the new sustainable finance regulation is precisely to crack down on so-called greenwashing. Regulators should play an essential role in identifying, preventing, and remediating greenwashing but they can not do this alone. Greenwashing is a complex and multifaceted issue which takes many forms. There is a clear role here for the European authorities to develop a cross-cutting definition of greenwashing and consider further sector-specific adaptations if needed.

Secondly, despite efforts made, the lack of enough data and criteria has led to some misalignment in the interpretation of key regulation concepts and possible inconsistencies in their EU-wide application.

Adaptation to the intensity and velocity of this regulatory wave will take time.

For instance, SFDR was not intended to be used as a labelling regime, but it is becoming one, and some areas remain open to a wide spectrum of interpretation. More work needs to be done on specifying minimum sustainability criteria, mainly for Article 8 funds, to reduce the current confusion in the market.

Furthermore, reliable and comparable corporate reporting is still lacking. The first EU Sustainability Reporting Standards (ESRS) will not be due until early 2025 since companies will need time to adjust. Additionally, the proposed ESRS bring their own challenges, such as the possible information overload and the need to ensure convergence with international initiatives without compromising the EU's sustainability ambitions.

Finally, another key challenge of this evolving regulatory framework is that it could lead to inconsistencies across regulatory requirements. The sustainable finance rulebook is complex, and it is important that all market participants understand how various texts are interlinked. I will just mention two examples: do no significant harm (DNSH) definition and differences between sustainable investment and activities in SFDR and the Taxonomy.

But, does this mean that we have to slow down the implementation and development of regulation?

Some may argue that legislators are going too far, too fast. It is true that some of the regulation may have too much detail, but I do not think the answer is to slow down, at least not regarding transparency and reporting. It is precisely the lack of a completed regulatory framework that increases the risks of greenwashing and the problems of lack of comparability, both between products and companies, as well as between jurisdictions. That is why it is more important than ever to increase efforts to ensure rules are comparable and consistently applied across jurisdictions.

To that end, regulators should apply the necessary flexibility so that market participants can adapt to the new requirements and navigate this new domain. But this is not enough. First, legislators should also understand the challenges that companies are facing and take this into account while completing the framework. Secondly, we all should increase coordination and cooperation. ESMA has a prominent role to play in ensuring supervisory convergence and offering guidance in achieving the desired level of transparency and comparability of financial products across EU jurisdictions.

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Proportionality needs to be considered much more in sustainability reporting

What gets measured, gets managed – that's probably a short way to summarize the thinking behind the EU's sustainable finance agenda. Consequently, the EU taxonomy was the starting point of the EU Commission's activities. It provides a common language of what can be regarded as sustainable. The next step was to increase transparency by disclosing the sustainability of financial products – via the Sustainable Finance Disclosure Regulation (SFDR). In order to know whether the assets behind the respective products are sustainable, companies must provide detailed information about the sustainability of their activities. This is where non-financial reporting according to the new Corporate Sustainability Reporting Directive (CSRD) comes into play.

The aim of the system is to increase transparency, so that investors can make better-informed investment decisions.

It seems though that when designing this system nobody had the "think small first" principle in mind. And it may be true that the framework was not targeted to SMEs or small and locally active financial institutions from the outset. But the focus of sustainable finance is no longer primarily on financial market investors, large listed companies and the capital markets. Today, the scope is much broader. This creates ongoing challenges in implementing the framework – especially for smaller banks and smaller companies.

The new reporting requirements are extremely comprehensive. For the first two environmental goals of the taxonomy regulation alone, more than 100 economical activities need to be checked and reporting templates with more than 1,500 data fields have to be filled in on a loan-by-loan basis. And this is just the beginning. For instance, the first set of the European Sustainability Reporting Standards (ESRS) currently developed by European Financial Reporting Advisory Group (EFRAG) foresees 137 mandatory disclosures and numerous data points. The amount of data that will created is just overwhelming for data users – which may find such a mass of data virtually impossible to evaluate – as well as providers. Especially for smaller financial institution and companies it means a big challenge.

A simple rule of thumb applies when it comes to the amount of effort caused by the data requirements: the smaller the bank or company, the bigger the burden.

Sustainability reporting should not lead to an unlevel playing field.

It was correct to spare SMEs from requirements that are already very burdensome for large enterprises. But this causes a SME conundrum: There is a lack of sustainability data for basically 99 % of enterprises in the EU and that will most likely not change any time soon. Further down the road, this will lead to several structural problems, especially for the financial institutions responsible for financing those SMEs. One example is the Green Asset Ratio (GAR). Supposedly a simple and catchy metric which banks will have to publish from 2024, suggesting objectivity. But loans supporting the transition of SMEs will not be reflected in the GAR, even if they are compliant with the taxonomy.

Moreover, the GAR in no way reflects regional characteristics, i.e. the operations of smaller, locally active institutions that are significantly affected by the economic environment within their radius of activity. Many banks are eager to support their corporate clients in their efforts to become more sustainable, but their efforts are not incentivised by the GAR. On the contrary, they may even harm them because they might appear less green.

What has to be done? Close attention must be paid to those aspects when developing the ESRS. The standards need to be as lean as possible and easy to apply. The focus should be on meaningful information. When it comes to the development of the future voluntary reporting standard for SMEs, it needs to be designed in a way allowing for full participation of SMEs in the transition to a sustainable economy. At the same time, it needs to provide the data necessary for financial institutions to fulfil their reporting requirements. Usability must be at the centre of the design of the ESRS. Already in the run-up it must be considered whether the data requested are available at all. Obtaining non available data must be considered under a cost-vs.-usefulness approach. Additionally, more time for implementation is needed and a timely provision of taxonomy-relevant data for corporate lending via the European Single Access Point (ESAP).

In summary, sustainability reporting needs to consider proportionality much more than it is the case now. Otherwise, reporting requirements will create an unlevel playing field to the detriment of SMEs and their financial partners. The CSRD has taken this into account to some extent, but it is only a first step in the right direction. More must follow.