legal insights

Green April: European Commission publishes sustainable finance and reporting package

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On 21 April 2021, the European Commission (ECOM) published measures aimed at fostering sustainable investment and steering finance towards the European Green Deal.

Introduction

As the ECOM noted in its communication of 21 April 2021, on the path of economic recovery from the COVID-19 pandemic and towards the European Green Deal, a sustainable financial ecosystem in Europe requires not only a clear transition and comprehensive framework for companies to follow, but also the promotion of transparency, reliability and comparability for investors and market participants, all while preventing greenwashing. Such conditions will allow green finance to work as a driving force towards the longer-term sustainable and inclusive economic development of Europe.

The first steppingstones have already been laid: the EU Taxonomy Regulation, the Sustainable Finance Disclosure Regulation and the Benchmark Regulation are all already in force, and form the foundation to increasing transparency. As the pivotal aspect, EU Taxonomy translates contribution to the EU's Green Deal objectives into (corporate) key figures on which investors can base their investment decisions.

As the next step in Europe's path towards the Green Deal, the Commission has published (see the ECOM's communication) a package consisting of:

- the EU Taxonomy Climate Delegated Act, which supplements the EU Taxonomy Regulation and sets out technical screening criteria for the sustainability of economic activities. This is designed to increase transparency for investors and to guide issuing/borrowing companies;
- a proposal for a Corporate Sustainability Reporting Directive (CSRD) that revises the Non-Financial Reporting Directive (NFRD) and extends the scope of companies required to disclose relevant data and of the information to be reported. Such uniform reporting standards (as envisaged under the CSRD) should also facilitate reporting by the respective company; and

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- related amendments to delegated acts to reflect sustainability preferences or considerations in insurance and investment advice, product governance and fiduciary duties.

1. The EU Taxonomy Climate Delegated Act

The EU Taxonomy Regulation, which entered into force on 12 July 2020, established a classification system for environmentally sustainable economic activities (Taxonomy framework). The EU Taxonomy translates contributions to the EU's Green Deal objectives into (corporate) key figures. It recognises activities that make a substantial contribution to reaching EU environmental objectives and that do not cause significant harm, as being sustainable.

On 21 April 2021, the College of Commissioners agreed on the text of the EU Taxonomy Climate Delegated Act (the "Delegated Act"), which supplements the EU Taxonomy Regulation. It provides technical screening criteria for determining whether an economic activity in a given sector can be considered as contributing substantially to climate change mitigation and climate change adaptation (which are two of the six environmental objectives set out in the EU Taxonomy Regulation). The Delegated Act will formally be adopted at the end of May and enter into force after the scrutiny period by the European co-legislators has ended. It is set to apply as of 1 January 2022. The Delegated Act covers the economic activities of roughly 40 % of EU-domiciled listed companies with more than 500 employees active in economic sectors responsible for nearly 80 % of direct greenhouse gas emissions in Europe (Taxonomy relevant sectors) (sources: Bloomberg, Eurostat; see the ECOM's communication, page 2). The Delegated Act notably covers the bioenergy, forestry, hydrogen and hydropower sectors. The EU Taxonomy includes more economic activities and more environmental objectives than have been used so far in market-based green financing frameworks.

To foster transparency, respective disclosure obligations are to be introduced for financial market participants. Disclosure will allow comparison and serve as a reliable guide for investment decisions, but also for companies to reliably plan (and raise financing) for their environmental transition. The Taxonomy framework will broaden the scope of currently existing green financing tools and, among other things, play a role in green bond standards and green financial retail products, as it enables market participants to design credible green financial products.

The criteria set out in the Delegated Act will also be subject to regular review, open to stakeholder input (via a web portal) and will be dynamically extended to new sectors and activities.

As the next step, the ECOM plans to adopt a complementary Delegated Act of the EU Taxonomy Regulation. This will apply to activities not yet subject to the present Delegated Act, such as certain manufacturing activities and energy sectors (e.g. nuclear energy and, to the extent aligned with the Taxonomy Regulation, natural gas and related technologies) as well as agriculture. The other four environmental objectives set out in the EU Taxonomy Regulation, i.e. the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems, will also be covered by a separate delegated act.

2. The new Corporate Sustainability Reporting Directive (CSRD)

As an ancillary step, the ECOM proposes to revise the Non-Financial Reporting Directive (NFRD) and introduces the proposed Corporate Sustainability Reporting Directive (CSRD). As a result, enhanced sustainability information may be used in financial analysis (whether by financial institutions or end-investors). Company reporting on their business models and strategies will be tailored to the financial markets participants and subject to disclosure by the Sustainable Finance Disclosure Regulation. Additional guidance will be provided by an ECOM proposal for a Sustainable Corporate Governance Initiative to follow later this year.

The CSRD is designed to include all large companies and all companies listed on EU regulated markets, except listed micro-enterprises. It will apply to approximately 49,000 companies in Europe, compared to approximately 11,000 companies to which the existing NFRD applies. By providing uniform (and mandatory) EU sustainability reporting standards, it may also reduce current expenses for companies confronted with a variety of different (non-harmonised) information requests for sustainability information. Information to be reported will include risks to the company arising from sustainability issues, the company's own impact on people and the environment (as is already the case pursuant to the NFRD), but also on global supply chains (e.g. compliance with international principles such as the Labour Organisation Declaration on Fundamental Principles and Rights at Work, no child labour, etc.). In accordance with the Capital Markets Union Action Plan, after being audited, such information would be fed into the European Single Access Point. Additionally, the ECOM builds on convergence initiatives on a global level, such as the Task Force on Climate-related Financial Disclosures (TCFD).

Specifically, the CSRD requires companies to disclose certain indicators, in particular the proportion of their turnover, capital expenditure (Capex) and operating expenditures (Opex) that are derived or associated with economic activities that qualify as environmentally sustainable. These indicators will, however, be further specified via a separate delegated act (to apply as of 2022). Other information, such as indicators aligned with the Sustainable Finance Disclosure Regulation, will have to be reported as well. Besides current Taxonomy alignment, reporting standards will also reflect forward looking business plans to enable both capital market-based and bank-based financing.

Reporting on climate change mitigation and climate change adaptation will apply as of January 2022. Reporting for the other four objectives is set to apply as of January 2023.

3. Going full circle

To ensure that sustainability considerations are taken into account on a systematic basis when offering financial instruments and products, the ECOM introduces obligations for insurance and investment advisors under delegated acts. These delegated acts supplement the Markets in the Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD). They will require financial intermediaries to obtain information from clients about their sustainability preferences. This will be in addition to the already existing suitability assessment (e.g. clients' investment knowledge and experience, risk tolerance, financial situation, etc.).

By amending duties in delegated acts for asset management, insurance, reinsurance and investment sectors, the ECOM extends the current obligations of (re)insurance companies, MiFID firms, Alternative Investment Fund Managers and others to include sustainability risks in the value of investments (e.g. impact of floods). The changes also affect financial product oversight and governance. Sustainability factors will have to be considered when designing investment and insurance products.

Conclusion

The "April package" is an important step towards the European Green Deal. The decision to invest in sustainable products or for companies to be Taxonomy-aligned is not legally mandated. However, setting sustainable standards on a global and unprecedented scale will likely cause green financial products to become compelling for investors.

In time, this legislative package will be supplemented accordingly and followed by further legal acts. The ECOM's take on transitional activities and sources of energy, which are not (yet) covered by EU Taxonomy but still reduce greenhouse gas emissions, is to be closely observed.