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THE EU'S SUSTAINABLE FINANCE LEGISLATIVE PROPOSALS – WHAT YOU NEED TO KNOW

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Following the publication of its Sustainable Finance Action Plan in March 2018 the EU Commission has published a series of legislative proposals which aim to embed sustainable finance into the heart of the investment process and harness "the vast power of capital markets in the fight against climate change and promoting sustainability". The proposals address three main areas – establishing an EU sustainability taxonomy, formalising investors duties and disclosure obligations in relation to environmental, social and governance (**ESG**) factors and the creation of low carbon and positive carbon impact benchmarks.

In common with much of the current work in the green finance sphere there is a focus on increased transparency and disclosure to the market and improved comparability for investors. Set out below are some of the key elements of the three proposals and a number of potential talking points. We also refer to a number of the comments made in the European Parliament's Resolution on Sustainable Finance which was published less than a week after the Commission's proposals.

Proposals

1. Taxonomy
2. Disclosure
3. Benchmarks

Proposals

1. Taxonomy

The Commission's proposal aims to develop a taxonomy for climate change and environmentally sustainable activities with the intention to embed this into EU law so that the classification system can be used in different areas, for example labels, standards and benchmarks. It sets out the criteria for determining if an activity (not a company or asset) is environmentally sustainable, but leaves future delegated regulations to detail the technical screening criteria. The proposal will apply to any EU or national regulator that sets out requirements relating to financial products or corporate bonds (notably not sovereign bonds) that are marketed as environmentally sustainable and also to financial market participants that offer financial products as environmentally sustainable investments.

When is an activity environmentally sustainable?
It is must satisfy four tests under the proposed legislation:

- contribute substantially to one or more of the environmental objectives
- not significantly harm any of the environmental objectives
- be carried out in compliance with minimum safeguards, essentially that the eight fundamental conventions identified in the International Labour Organisations' declaration on Fundamental Rights and Principles at Work, such as non-discrimination, equal pay and the right to organise, are observed.
- comply with any specified technical screening criteria

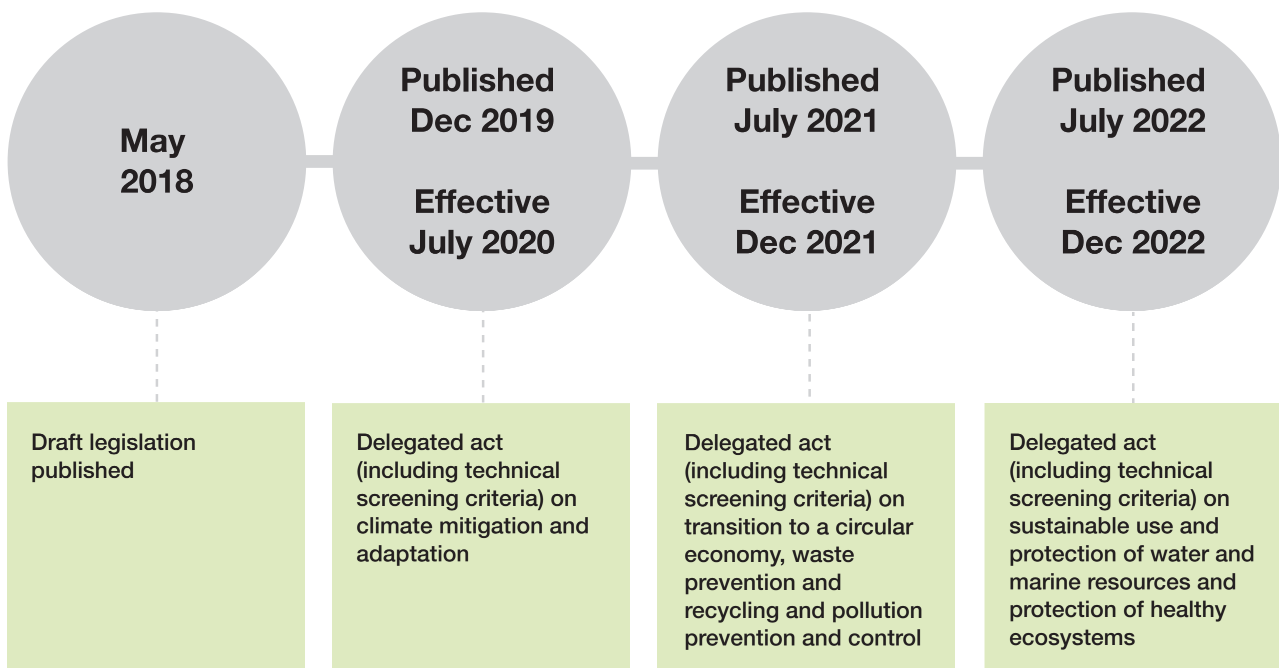
The technical screening criteria
The proposal details how the relevant technical screening criteria for each environmental objective should be developed. This includes considering both the short term and long term impact of the activity, specifying the minimum requirements to be met to avoid significant harm, basing the criteria on conclusive scientific evidence and ensuring compliance with the criteria can be verified.

Timeline
These proposals will now be discussed by the Parliament and the Council. However, the Commission is already in the process of establishing a technical expert group on sustainable finance which will, amongst other things, develop proposals for the Commission on the technical screening criteria. We understand applications to join such group are high. Once agreed the technical screening criteria will be adopted in a delegated act for each environmental activity over a staggered timetable with the intention that there is a six month period between publication of the criteria and its implementation via the Regulation.

What are the environmental objectives?

- climate change mitigation
- climate change adaptation
- sustainable use and protection of water and marine resources
- transition to a circular economy, waste prevention and recycling
- pollution prevention and control
- protection of healthy ecosystems

Further (non-exhaustive) detail is provided on each environmental objective which we have summarised in the annex to this briefing.



2. Guidance and disclosure of ESG risks

This proposal requires institutional investors to consider and disclose, in a consistent and harmonised manner, how ESG factors are adopted in their decision making and advisory processes. In summary, it requires:

- website publication of how sustainability risks are incorporated into investment decision making processes or investment or insurance advice (as applicable);
- the inclusion of various elements of sustainability risks in pre-contractual disclosures, including the impact of sustainability risks on returns of any financial product;
- in respect of financial products marketed as sustainable investments, website disclosure of the sustainable investment target and the methodologies used to measure the impact of the investment plus the provision of periodic reports detailing the sustainability-related impact of the financial product;
- all the specified website disclosures to be kept up to date; and
- any marketing communications must not conflict with the other disclosures required by the regulation.

In addition, an amendment to the IORP Directive is proposed which would amend the 'prudent person' rule to require that ESG factors are taken into account in investment decisions and risk management.

The intention of this new regulation is that better disclosure will lead to greater and more comparable information on sustainability risks and opportunities being made available to end investors. The proposals will apply the new requirements in accordance with existing EU legislation applicable to asset managers, insurance undertakings, pension funds and investment advisors.

3. Benchmarks

This draft regulation amends the existing Benchmark Regulation by introducing two new types of benchmarks:

- a low carbon benchmark, where the underlying assets have less carbon emissions that a standard investment index; and
- a positive carbon impact benchmark, composed of assets where the carbon emission savings exceed their carbon emissions, thus providing an opportunity for investors to identify with portfolios that aim to meet the 2 degrees celsius objective in the Paris Climate Agreement.

There will be future delegated acts which will give further detail on the minimum standards for each of the new benchmarks, but the legislation stops short of a fully harmonised methodology or requesting benchmarks to be established. Notably however, the annex requires that benchmark providers disclose how data on 'scope 3 emissions', or emissions that are a consequence of the operations of a company but not directly controlled by the company (such as customer emissions), is used in their selection criteria. It is hoped further clarity on this and other methodology will encourage investor confidence.

The new requirements also oblige benchmark administrators of benchmarks that pursue ESG objectives to publish key elements of their methodologies and include in their benchmark statement an explanation of how ESG factors are reflected. Again, further detail on these provisions will be set out in future delegated acts.

4. MiFID 2

The Commission has also published a draft amendment to MiFID 2 which would require firms to specifically take into account a client's ESG preferences as part of their investment objectives and to include ESG considerations in their description of and advice in relation to financial instruments.

Talking Points

1. Challenges of preparing and applying the taxonomy

It is no surprise that the Commission has phased the preparation of the technical criteria which will govern the determination of whether an activity is environmentally sustainable - it is going to be a challenging, and potentially sensitive, task. Three dilemmas already present themselves:

- The threshold for sustainability: The bar is set at a fairly high level – activities have to make a "substantial contribution" to the relevant objectives before they can be considered sustainable. Care will need to be taken to avoid informally denoting neutral-to-positive activities as environmentally unsustainable, and the consequent risk of related assets becoming "stranded assets".
- Granularity of application: Ultimately asset managers and other finance professionals will need to apply the taxonomy to particular investments in companies or assets. This will be easier where the criteria have a high degree of granularity. Reference to existing EU and other standards may be sufficient in some sectors but new standards may need to be created in others. In prior consultations, respondents favoured building upon existing classifications (such as the work of the Climate Bonds Initiative and Eurosif) but there remains much to be done. Even with detailed criteria, the task of balancing the sustainability positives against any sustainability harms is likely to be a complex and potentially resource-intensive process. Monitoring the sustainability of investments over time may also prove a challenge. Could this deter the use of "environmentally sustainable" labels?
- Geographical reach: The task is also destined to be a significantly complex one, not least given that it will apply to activities on a global basis. In some cases, it will be necessary to distinguish between the impacts of activities in different locations– what is sustainable in one area may not be sustainable in another. The Commission has already grappled with a similar environmental sustainability dilemma with impacts outside the EU in relation to the sustainable production of biofuels. While the EU has established criteria on the characteristics of land that biofuels can come from, it has so far shied away from legislating on the question of whether displacement of biofuels contributes to food poverty in developing countries. However, will the Commission in the context of the sustainable finance taxonomy be prepared to designate biofuel production as "environmentally sustainable" in areas where this social risk is shown to exist? The Commission states that it will look, in due course, to extend the taxonomy to socially sustainable activities, and the balance between environmental and social objectives will no doubt eventually have to be addressed.

Talking Points

- Challenges of preparing and applying the taxonomy
- Potential tensions with the GBPs and GLPs
- Impact of disclosure rules
- Shades of green investing
- Green supporting factor vs brown penalising factor
- What's to come

2. Potential tensions with the Green Bond Principle and Green Loan Principles

It is notable that none of the draft proposals or any of the supporting documents published by the Commission mention the Green Bond Principles (**GBP**) or the newly published Green Loan Principles (**GLP**), aside from a short comment in the fact sheet that market led initiatives are not sufficiently comprehensive. Both the GBP and GLP list eligible projects that can be funded by green bonds or loans in accordance with the relevant principles and, although these are deliberately high level compared to the proposed granularity of the taxonomy, there is a substantial degree of overlap. However, the Commission's proposals do not identify any mechanism for how issuers or borrowers that currently comply with the GBP or GLP, respectively, might transition to ensure compliance with the new taxonomy. Might the lack of discussion on how the new taxonomy and GBP and GLP could dovetail for future green financings discourage new green bond issuance or green loans being entered into in the period before the taxonomy is finalised? We also know that a Commission report on the establishment of an EU green bond standard is expected by Q2 2019. It would be unfortunate if uncertainty inadvertently put the brakes on the green bond market which broke the USD100bn barrier last year for the first time or prevent uptake of the GLP which were only published in March.

3. Impact of new disclosure rules

The rules on disclosure to investors of ESG risks and the approach of asset managers on the integration of ESG risks into investment decisions will be an additional set of disclosures on top of existing requirements. So, for example, for an alternative investment fund manager these would be in addition to the set of information disclosures to investors already required under the Alternative Investment Fund Managers Directive. The disclosure requirements will apply to AIFMs, UCITS managers and managed/segregated accounts, and will be disclosures to be included in material such as prospectuses or offering documents (and would also need to be kept under review in case the disclosures need to be updated).

Disclosure items, such as on the procedures and conditions applied for integrating sustainability risks in investment decisions and how an asset manager's remuneration policies are consistent with the integration of sustainability risks, will apply whether or not the particular fund or managed account has as its target sustainable investments. For funds or managed accounts with no sustainability focus, managers are going to need to consider whether in practice this just translates into a very simple, limited form of additional disclosure (essentially a "tick box" exercise) or whether investor expectations will be shifted so managers need to consider sustainability more generally in investment process and strategy.

Funds or managed accounts with a sustainability focus will, on top of this, have additional disclosure requirements on the methodologies used to measure the impact of the investment and the sustainability-related impact of the product. Greater conformity on information and disclosures on sustainability for those products are potentially helpful in developing an EU label for "green" funds. In particular from a private fundraising perspective we can expect to see even more focus on these areas during the negotiation process as institutional investors seek to ensure they are able to obtain the appropriate reporting from the fund manager in order to meet disclosure and compliance requirements themselves. This will be important in the context of long-term funds (particularly infrastructure) where a fund closing now will likely be making investments after the legislation comes into effect.

4. Shades of green investing

The development of two distinct types of benchmarks, low carbon and positive carbon impact, supports the approach that the green finance market can develop to allow for financing of projects that reflect all shades of green. The low carbon benchmark can be used for 'lighter' green investments and 'dark' green investors are able to align their strategies with the positive carbon impact benchmark. This is a sensible and pragmatic approach by the Commission and aligns with the approach taken by the GBP. However, following concerns raised by the Regulatory Scrutiny Board around costs, the Commission reversed a requirement for benchmark methodologies to use the new taxonomy. This may lead to inconsistencies across the market and a diminution of comparability for investors further down the line.

5. Green supporting factor vs brown penalising factor

There has been much recent debate on the controversial concept of a 'green supporting factor' which would tilt bank regulatory capital risk weightings in favour of green assets. This was explicitly referred to in the Commission's Sustainable Action Plan. Another suggestion mooted in the HLEG's interim report was the idea of altering risk weightings against brown assets rather than in favour of green assets. The interim report concluded that this approach would not undermine the policy driver behind risk weightings given that potential stranded assets are indeed likely to be 'riskier'. However, this idea has not received as much attention as the green supporting factor and did not appear in the HLEG's final report. Now the explanatory memorandum of the taxonomy proposal seems to confirm the rejection of this idea in the repeated words [emphasis added] that 'the proposed measures create incentives for investing in green activities *without penalising other investments*' although this is clearly not a definitive statement. The possibility of an EU policy statement on recalibration of capital requirements (in some form) remains, in particular given the support of the idea by European Parliament in its Resolution on sustainable finance. The timing of any policy statement from the Commission is unclear and realistically may need to wait until the taxonomy is further developed and embedded in the market.

6. What's to come?

The current proposals are expected to be just the start of the Commission's legislative measures designed to implement its Action Plan. We anticipate the following areas will receive increasing focus:

- Development of green standards and labels - although much of the work here will only be possible once the taxonomy is fully functioning. The European Parliament suggests that a 'Green Finance Mark' be granted to investment, equity and pension products that achieve the highest standards in the sustainability taxonomy. Interesting the Parliament's proposal also recognises the value of a shades of green criteria by acknowledging that standards can identified for activities that "do no harm" and those that have a "positive impact".
- European green bond standards – the European Parliament calls for a unified European standard for green bonds building on the work of the taxonomy. The Commission's Action Plan also confirmed it will prepare new rules for green bond prospectus disclosure and intends to publish a report on the establishment of an EU green bond label in Q2 2019. Those in the green bond market will follow this potential work stream closely and will be wary of any mismatch with the GBPs.

- Deeper integration of ESG factors into credit ratings – the Action Plan set out the Commission's proposals to review current market practices and consider amendments to the Credit Rating Agency Regulation. The European Parliament recommends that credit rating agencies are required to incorporate sustainability risks into their methodologies.
- Disclosure and accounting – we may see the adoption of the Financial Stability Board's Task Force on Climate-related Financial Disclosure (TCFD). This is certainly what the Parliament would like, and many concerns raised with regard to integration of ESG factors into investment decisions pointed to the lack of high quality, comparable data from corporates. The Commission's "fitness check" will be undertaken on public corporate reporting, including the Non-Financial Reporting Directive, and there will be a review of the negative impact of IFRS 9. Further legislative proposals are likely to follow.
- Mainstreaming – many of the individual ideas expressed in the Action Plan and Parliament resolution essentially go towards ensuring that ESG considerations become fully embedded in the mainstream of all financial decisions. Improved disclosure and transparency, low carbon and sustainability benchmarks, credit ratings that address ESG factors and eco labelling are intended to empower more investors, including retail, to engage in green and sustainable investments. The European Parliament's suggestions about aggregation and a focus on SMEs aim at ensuring the 'green' revolution is accessible by all companies and smaller scale market participants. Adoption of TCFD, revisions to accounting standards and the Non-Financial Reporting Directive mean that companies and institutions need to consider these questions, they will need to ask their suppliers and investee companies about these issues and in turn their clients will ask them - this is the ripple out effect we are already seeing and could provide the game-changer we need.

Annex

The tables below summarise the 'substantial contribution' and 'significant harm' criteria for each of the environmental objectives set out in the taxonomy proposal discussed above

Climate change mitigation

Substantial contribution: activity that contributes substantially to stabilisation of greenhouse gas concentrations by reducing emissions or enhancing removals

Through:

- Generating, storing or using renewable energy or climate-neutral energy
- Improving energy efficiency
- Increasing clean or climate-neutral mobility
- Switching to use of renewable materials
- Increasing carbon capture and storage use
- Phasing out anthropogenic emission of greenhouse gases
- Establishing energy infrastructure to enable decarbonisation of energy systems
- Producing clean and efficient fuels from renewable or carbon neutral sources

Significant harm: activity leading to significant greenhouse gas emissions

Protection of water and marine resources

Substantial contribution: activity that contributes substantially to good status of waters (including freshwater and coastal waters) and to good environment status of marine waters

Through:

- Protecting aquatic environment from the adverse effects of urban and industrial waste water discharges
- Protecting human health from adverse effects of any contamination of drinking water
- Abstracting water in accordance with good quantitative status objectives
- Improving water efficiency, facilitating water reuse
- Ensuring sustainable use of marine ecosystem services or contributing to good environmental status of marine waters

Significant harm: activity that is detrimental to a significant extent to good status of Union waters

Climate change adaptation

Substantial contribution: activity that contributes substantially to reduction of the negative effects of the current and expected future climate change; preventing an increase or shifting of negative effects of climate change

Through:

- Preventing or reducing the location and context-specific negative effects of climate change
- Preventing or reducing the negative effects that climate change may pose to the natural and built environment within which the economic activity takes place

Significant harm: activity leading to increased negative effect of current and expected climate for and beyond the natural and built environment within which that activity takes place

Circular economy, water prevention and recycling

Substantial contribution: activity that contributes substantially to the Circular economy, water prevention and recycling

Through:

- Improving efficient use of raw resources
- Increasing durability, reparability, upgradability or reusability of products
- Increasingly recyclability of products
- Reducing content of hazardous substances in materials and products
- Prolonging use of products
- Increasing use of secondary raw materials and their quality
- Reducing waste generation
- Increasing preparing for re-use and recycling of waste
- Avoiding incineration and disposal of waste
- Using natural energy resources efficiently

Significant harm: activity that leads to significant inefficiencies in the use of materials in one or more stages of the life-cycle of products or activity that leads to a significant increase in the generation, incineration or disposal of waste

Pollution prevention and control

Substantial contribution: activity that contributes substantially to a high level of environmental protection from pollution

Through:

- Reducing air, water and soil pollutant emissions other than greenhouse gases
- Improving levels of air, water or soil quality where economic activity takes place while minimising negative impacts on human health and environment
- Minimising significant adverse effects on human health and environment of production and use of chemicals

Significant harm: activity that leads to a significant increase in emissions of pollutants to air, water and land

Healthy ecosystems

Substantial contribution: activity that contributes substantially to protecting, conserving and enhancing biodiversity and ecosystem services

Through:

- Nature conservation; protecting, restoring and enhancing condition of ecosystems and their capacity to provide services
- Sustainable land management; land degradation neutrality; remediation of contaminated sites
- Sustainable agricultural practices
- Sustainable forest management

Significant harm: any activity detrimental to a significant extent to the good condition of ecosystems

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