CLIFFORD CHANCE

THE EU SUSTAINABLE FINANCE ACTION PLAN

an update report

April 2019

THE EU SUSTAINABLE FINANCE ACTION PLAN – AN UPDATE REPORT

As the current European Parliament's term draws to a close it is an opportune time to take stock of the progress made under the Commission's Sustainable Finance Action Plan (the "SFAP"). The SFAP published in March 2018 is ambitious with three broad aims (1) to reorient capital flows towards a more sustainable economy, (2) to mainstream sustainability in risk management and (3) to foster transparency and long-termism. These aims are scoped in further detail in 10 separate action points. Some of the action points have been more fully realised than others but the progress made in a year is impressive and reflects the EU's commitment to the sustainability and low-carbon transition agenda.

Summary

- The Sustainable Finance Action Plan (SFAP) one year on
- Legislative achievements: Disclosure Regulation, Low Carbon Benchmark Regulation and suitability regulations
- Status table showing progress of the 10 action points under the SFAP
- A more detailed look at:
  - the Taxonomy Regulation
  - the Disclosure Regulation
  - the EU Green Bond Standard
  - the Low Carbon Benchmark Regulation

WHAT HAS HAPPENED SO FAR

Notable achievements relate to the four legislative proposals published by the Commission in May 2018, three of which, the Disclosure Regulation, Low Carbon Benchmark Regulation and suitability regulations (each as defined in the status table on page 6), have already been agreed. The fourth relates to the sustainable taxonomy regulation which is the most complex element of the SFAP and is discussed in more detail below. In addition to these legislative proposals the requirement to consider sustainable and ESG (environmental, social and governmental) factors has been drafted into wide ranging categories of regulation by way of consultations, guidance documents and draft legislation (including those not covered by the SFAP such as the Investment Firms Regulation) and, although not all yet finalised, they clearly demonstrate the direction of travel. Some of the more contentious or difficult topics identified in the SFAP are still up for discussion and require further work including the already mentioned sustainable taxonomy and the proposed recalibration of capital requirements to support sustainable activities. The composition of the new European Parliament, following elections in May, will to some extent determine how these topics develop over the coming months.

STATUS TABLE

Our status table on page 6 reflects progress made to date on each of the 10 action points by reference to the proposals flagged in the SFAP; however it is not a fully comprehensive overview of all the work undertaken by the EU in this area given the scale and breadth of this project. We have also highlighted below a few areas worthy of more detailed attention.

TAXONOMY REGULATION

- This provides the centrepiece of the SFAP and is widely recognised as being the most technically difficult proposal to agree. In short, it is the EU's method of defining if an economic activity is environmentally sustainable.
- The Commission published its proposals in May 2018. It outlined the following six broad environmental objectives that will form the basis of the taxonomy: (i) climate change mitigation, (ii) climate change adaptation, (iii) sustainable use and protection of water and marine resources, (iv) transition to a circular economy, waste prevention and recycling; (v) pollution prevention and control and (vi) protection of healthy ecosystems. These objectives will be backed by detailed technical screening criteria which are under development by the Technical Expert Group on sustainable finance (the "TEG"). In addition to complying with the technical screening criteria any activity must not cause significant harm to any of the six environmental objectives.
- The Parliament finalised its proposals on 28 March 2019 but the Council is yet to publish its position. Trilogue discussions between the Parliament and the Council are expected following publication of the Council's position and these may result in further compromise proposals.
- The Parliament's proposals go further than the Commission's original draft. Key differences include the blanket exclusion of fossil fuel and nuclear from the technical screening criteria; the requirement that the Commission conduct an assessment for a "brown" taxonomy by end of 2021; an emphasis on the taxonomy determining the *degree* of sustainability that should be assessed across the value chain and whole life cycle; additional disclosure requirements for prospectuses and a greater emphasis on monitoring compliance by financial market participants.
- The Parliament's final proposals reflect a compromise and a number of the interim proposals discussed such as expanding the taxonomy to include brown and social activities (although the requirement to consider a brown taxonomy by the end of 2021 was included) and making the taxonomy applicable to all financial products were ultimately dropped (although certain disclosures are required in relation to financial products that are not environmentally sustainable). As noted above certain MEPs pushed for (and succeeded in getting) an exclusion of nuclear power from the taxonomy, but this is unlikely to be universally applauded given that many in the market consider nuclear to be a necessary energy source during the low carbon transition period. Indeed, the draft taxonomy itself recognises the importance of the supporting activities that assist with the transition process.
- The TEG has begun work on developing the technical screening criteria for the climate change mitigation objective, including a request for feedback and collection of expert evidence. TEG expects to publish its final report covering climate change mitigation and climate change adaption in June 2019.
- The development of a taxonomy divides opinion amongst market participants. Having clear, objective and comparable standards would self evidentially be of great benefit to encourage growth in the market as well as enabling governments and regulators to develop policy measures based off such standards. However, the technical difficulty in devising standards that satisfy the requirements to be objective and specific while also encompassing a broad range of activities and not being so prescriptive as to be practically onerous, which would put off market participants and lead to a slower pace of transition, is a significant challenge. In addition, the 'no significant harm' principle, whereby the sustainability benefits of a particular project need to be weighed against any potential negative sustainability outcomes, would appear to require expert subjective assessment and may lead to practical difficulties in implementation.

DISCLOSURE REGULATION

- This proposal deals with the second broad aim of the SFAP to mainstream sustainability in risk management and sets out disclosure requirements concerning how institutional investors and asset managers integrate ESG factors into their risk processes.
- The Commission published its proposals in May 2018 and the Council and Parliament reached a political agreement on the regulation in March 2019, however official publication is unlikely until after the Parliament elections in May 2019.
- The regulation requires financial market participants to (i) publish information on their policies on the integration of sustainability risks in their investment decision-making processes, (ii) include certain sustainability-related considerations in their pre-contractual disclosures and periodic reports and (iii) publish certain sustainability-related information on their websites for relevant financial products they offer.
- It addresses the concern that disclosures in the asset management, insurance and pensions sectors can be unsystematic and fail to ensure comparability (making it difficult and costly for end-investors to make informed investment choices) by harmonising the divergent disclosure standards and market-based practices among member states.
- Further detail on the content, methodologies and presentation of the required disclosures will be set out in the relevant regulatory technical standards to be developed by the joint committee of ESAs as set out in the proposed regulation. Most of these technical standards are due to be developed and submitted to the Commission within 12 months of the regulation entering into force.
- Although various industry bodies have voiced support in principle for the objectives of the proposed regulation, concerns have been raised about the cost implications for reviewing and amending pre-contractual and contractual documentation, the potentially duplicative disclosure requirements and the timeline for implementation.

LOW CARBON BENCHMARK REGULATION

- This proposal to establish new low-carbon labels for benchmarks set out by the Commission in May 2018 was agreed by the Parliament and Council in February 2019. The new types of benchmark introduced by this regulation are intended to assist investors in identifying and pursuing low carbon investment strategies.
- The provisions make amendments to the existing Benchmark Regulation to allow for a voluntary low-carbon label to be applied to benchmarks that satisfy the requirements of the new regulation. There are two distinct labels - the "EU Paris -aligned benchmarks" for use if the indices align with the long-term global warming target of the Paris Climate Agreement and the "EU climate transition benchmark" if the indices comprise companies that follow a decarbonisation trajectory (this is defined in the regulation) by December 2022, but do not satisfy the higher Paris Agreement target.
- The new provisions also require all benchmark administrators to include in their benchmark statements the extent to which they consider ESG factors or a statement that they do not pursue ESG objectives. Administrators of "significant" equity and bond benchmarks must include detailed disclosure on the extent to which the benchmark aligns with carbon emission reduction or the long-term global warming target of the Paris Agreement.
- Further detail on the application of these provisions will be given in delegated regulations.

EU GREEN BOND STANDARD

- The TEG was mandated by the Commission to, amongst other matters, develop an EU wide green bond standard in line with the wider recommendations the SFAP. The outline of a new standard was suggested in the reports of the EU High-Level Expert Group of Sustainable Finance published in July and December 2018 and forms part of a wider push by the Commission to create harmonised standards and labels for "green" financial products with aim of protecting integrity and trust in sustainable financial markets.

- The TEG published its interim report on a "Proposal for an EU Green Bond Standard“ on 6 March 2019.

The EU Green Bond Standard ("GBS") – The Basics

- To qualify as an "EU green bond", the proceeds of the issue, or an amount equal to such proceeds, shall be allocated only to finance or refinance "green projects" defined, subject to confirmation by an accredited external reviewer as (a) contributing substantially at least one of the EU’s "environmental objectives“ (which are based on the current principles of the Taxonomy Regulation) while (b) not significantly harming any of the other objectives and (c) complying with the minimum social safeguards represented by the principles and rights set out in the eight fundamental conventions identified in the International Labour Organisation’s declaration on Fundamental Rights and Principles at Work.

- In addition, an issuer of a EU green bond is required to produce a Green Bond Framework ("GBF") which confirms the voluntary alignment of green bonds issued following this GBF with the GBS and provides details on all the key aspects of the proposed use of proceeds and on its green bond strategy and processes.

- Finally, issuers of EU green bonds are required to report annually until full allocation of proceeds. A standardised format for reporting has been proposed by the TEG with the aim of further harmonising disclosures.

Alignment with the ICMA Green Bond Principles

- Much like the ICMA Green Bond Principles (the "ICMA GBP"), the proposed GBS is a "use of proceeds" based standard and much of the architecture of ICMA GBP is embedded in the proposed GBS.

- There are however a few key points to note:

  - use of proceeds must comply with a the EU's stated environmental objectives and, when it is in force, the Taxonomy Regulation;
  - external reviewers will need to be accredited by ESMA whereas the ICMA GBP has no such accreditation obligations; and
  - whilst the EU GBS is intended to be voluntary it is more prescriptive in its drafting that the ICMA GBP and the development of the Taxonomy Regulation needs to be taken into account. The current draft of the Taxonomy Regulation requires that financial products such as bonds that are marketed within the European Union as environmentally sustainable will need to comply with the definitions of environmentally sustainable activities as set out in that Regulation. If that requirement is included in the final text of the Taxonomy Regulation in the Official Journal it is difficult to envisage a scenario where the EU GBS would not be required to be used for green bonds offered into the European Union.

- The TEG has actively sought input and feedback on the proposed GBS and intends to use that feedback for the its final report to be presented to the European Commission in June 2019.

	SFAP action point	Status	Next Steps
Actions aimed at reorienting capital flows towards a more sustainable economy			
1.	Establishing an EU classification system for sustainable activities (the "Taxonomy Regulation")	The Commission published its proposal in May 2018. The European Parliament published its proposal on 28 March 2019. The Council has not yet published its position. The Commission requested that the Technical Expert Group on sustainable finance ("TEG") assist in developing its legislative proposals including looking at the taxonomy. TEG published its proposals on activities that contribute to climate change mitigation and the usability of this list of activities in December 2018. Feedback period on the proposals closed on 22 February 2019.	Q2/3 2019: Council to publish its position followed by trilogue discussions between Parliament and Council. Q2 2019: TEG to publish final report. Q4 2019: Delegated Act on climate change mitigation and adaptation to be published and effective Q2 2020.
2.	Creating standards and labels for green financial products	The Commission also requested that TEG assist in developing an EU Green Bond Standard ("EU GBS"). TEG published its Interim Report on the proposed EU GBS in March 2019. Feedback period on the proposals closed on 7 April 2019.	Q2 2019: TEG to publish final report.
3.	Fostering investments in sustainable products	No new information publicly available	
4.	Incorporating sustainability when providing financial advice (the "suitability regulations")	The Commission published draft delegated regulations in January 2019 amending MiFID II and the Insurance Distribution Directive to ensure that investment firms and insurance distributors to take sustainability issues into account when advising clients. The suitability regulations can only be adopted when the new Disclosure Regulation (set out in action point 7) has been agreed. However, the intention is that the draft rules ensure that investment firms and insurance distributors can prepare to take ESG factors into account in the suitability assessments they undertake.	Official publication of the suitability regulations depend on the timing of the Disclosure Regulation as set out in action point 7.
		ESMA Guidelines on certain aspects of MiFID II suitability requirements published in November 2018 specify that it is good practice for firms to collect information on the client's preferences on ESG factors.	Completed.
5.	Developing sustainability benchmarks (the "Low Carbon Benchmark Regulation")	The Commission published its proposals in May 2018. The European Parliament and Council reached political agreement on 25 February 2019 and the regulation is proceeding through the EU legislative process.	Q3/4 2019: official publication.
Actions aimed at mainstreaming sustainability into risk management			
6.	Better integrating sustainability in ratings and market research	ESMA published a consultation paper on the Credit Rating Agencies Regulation in December 2018 and this included proposed guidance on improving the quality of rating agency disclosure on ESG factors. Consultation now closed.	Q3 2019: ESMA to publish final report.

	SFAP action point	Status	Next Steps
7.	Clarifying institutional investors' and asset managers' duties (the "Disclosure Regulation")	The Commission published its proposals in May 2018. The Parliament and the Council reached political agreement on 8 March 2019 and the regulation is proceeding through the EU legislative process. Separately the Commission requested technical advice from ESMA and EIOPA in July 2018 on how asset managers, insurance companies and investment or insurance advisors should integrate sustainability risks into organisational requirements, operating conditions, risk management and target market assessment requirements. This would involve changes to UCITS, AIFMD, MiFID II, Solvency II and IDD. Consultations launched in November and December 2018 and now closed.	Q3/4 2019: official publication. April 2019: ESMA and EIOPA to provide technical advice based on consultation response.
8.	Incorporating sustainability in prudential requirements	Proposed CRD 5 directs the EBA to assess whether ESG risk should be included in the supervisory review and evaluation process by competent authorities. Proposed CRR requires large institutions with securities admitted to trading on an EU regulated market to disclose information on ESG related risks, including physical and transition risk.	Q2/3 2019: official publication. Q2/3 2021: EBA to publish report. Q2/3 2022: CRR requirement to apply.
		The Commission requested EIOPA to provide an opinion on sustainability within Solvency II in August 2018. EIOPA requested evidence from market participants on the integration of sustainability risks and factors in (re)insurers investment and underwriting. Submission period now closed.	Q3 2019: EIOPA to publish opinion.
	Actions aimed at fostering transparency and long-termism		
9.	Strengthening sustainability disclosures and accounting rule making	The Commission ran a consultation from March to July 2018 on a number of pieces of legislation as part of its "fitness check" on EU legislation relating to public corporate reporting, including the Non-Financial Reporting Directive ("NFRD") and the IAS Regulation.	Q2 2019: Commission to report on the overall fitness check in a Commission Staff Working Document.
		In January 2019 the TEG published its report on climate-related disclosures (including on NFRD) followed by a Commission consultation on its proposed revisions to the non- binding guidelines to the NFRD. Consultation ended on 20 March 2019.	Q2 2019: Commission to publish revised guidelines.
		The European Reporting Lab@ EFRAG was established in September 2018 to encourage innovation in corporate reporting and sharing of best practice. It launched its first project on climate-related reporting in February 2019.	No date specified for completion of the project.
10.	Fostering sustainable corporate governance and attenuating short-termism in the capital markets .	In February 2019 the Commission requested advice from ESMA, EBA and EIOPA on undue short-term pressure from the financial sector on corporations.	Q4 2019: final advice expected.
		In January 2019 the Commission ran a conference on sustainable corporate governance to discuss policy developments and share best practice.	No detail on next steps provided.
		The revised Shareholder Rights Directive aims to promote effective stewardship and long-term investment decision making.	Q2 2019: applies in all Member States.

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Clifford Chance has a large global team of experts that cover a breadth of sustainability issues including those relating to: environmental regulation; sustainable finance (including green and social bonds, green securitisations and green and social loans); renewable energy; asset and fund managers; and climate risk and litigation.

Please contact one of the authors or your usual Clifford Chance contact to be put in touch with one of our experts.

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