Client Alert | Capital Markets

EU Sustainable Finance Regulation

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The EU sustainable finance market has developed organically, guided by voluntary but universally accepted principles. According to recent research, climate change could cost up to 19 per cent. of Global GDP by the end of 2030[1]. In response to this, policymakers have now stepped up regulatory intervention to ensure a more rapid transition to a low carbon economy to help mitigate risks and negative impacts caused by climate change.

Background

In 2015, various international agreements, such as the Paris Climate Agreement ("**COP 21**")[2] and the United Nation's 2030 Agenda and Sustainable Development Goals ("**UN SDGs**")[3], were finalised, and as part of their commitment to achieve these goals, the European Commission (the **"Commission**") developed and unveiled its Action Plan on Sustainable Finance (the "**EU Action Plan**")[4]. COP 21 sets a series of global climate change commitments and goals, which include: defining the scope of what is sustainable; building sustainability considerations into financial regulation; and ensuring transparency. The EU Action Plan aims to provide a regulatory framework to support and promote sustainable investment in the EU in line with these global climate change commitments.

Building Sustainability into the EU Financial Ecosystem

According to the Commission, sustainable finance refers to the process of taking due account of environmental and social considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities. The EU Action Plan will be implemented through the incorporation of sustainability considerations and requirements into its core suite of financial regulations. The Commission intends to establish an EU framework that puts environmental, social and governance ("**ESG**") considerations at the heart of the financial system to help transform Europe's economy into a greener, more resilient and circular system.

EU Strategy on Sustainable Finance

At the end of 2016, the Commission appointed a High-Level Expert Group ("**HLEG**") on sustainable finance which, on 31 January 2018, published its final report offering a sustainable finance strategy for the EU. The report flags two urgent EU imperatives: the need to improve the contribution of finance to sustainable growth by funding society's long-term needs and to strengthen financial stability by incorporating ESG factors into investment decision-making.

The EU's Technical Expert Group on sustainable finance ("**TEG**") was also formed at the direction of the Commission to develop four key foundations for a codified sustainable finance market. The EU Action Plan's

1 http://ccsl.iccip.net/climate_resilient.pdf

2 https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

3 https://sustainabledevelopment.un.org/topics/sustainabledevelopmentgoals

4 http://europa.eu/rapid/press-release_IP-18-1404_en.htm?locale=en

aim is to transform the EU's economy into a greener, more resilient system to reduce the EU's carbon footprint, boost competitiveness by improving efficiency of production and reduce costs of resources. The strategy comprises the following key recommendations:

1. Establish and maintain a common sustainability taxonomy at the EU level (the "**EU Taxonomy**") and develop EU sustainability ("**ECO**") standards and labels;

2. Foster transparency and long-termism in financial and economic activity by:

   - moving focus away from short-term performance (as investments into environmental and social objectives require a long-term orientation);

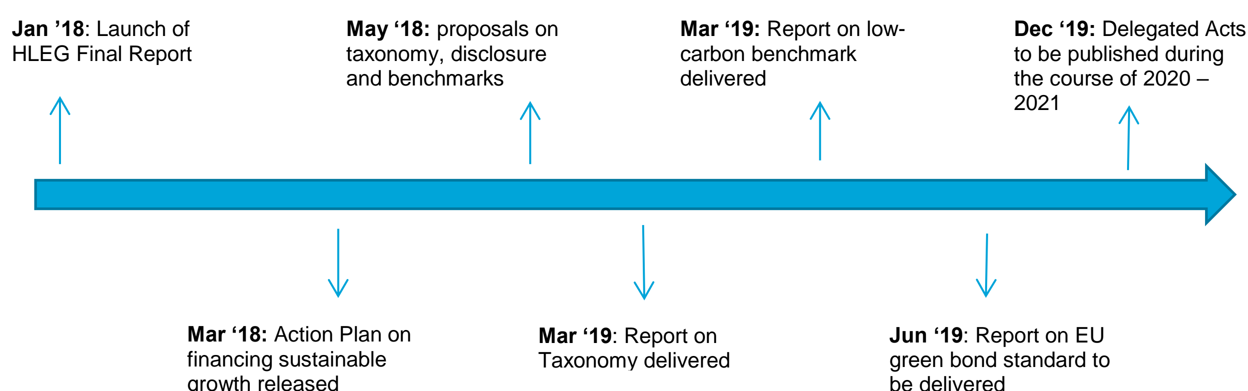
   - upgrading disclosure rules to make sustainability risks fully transparent (thereby allowing investors to take better informed and more responsible investment decisions); and

   - promoting a retail investment savings strategy which includes making ESG part of any investment advice;

3. Develop an EU green bond standard ("**EU GBS**"); and

4. Develop benchmarks for low-carbon investment strategies.

Timeline



The EU Taxonomy

The TEG released its draft taxonomy for sustainable economic activities in December 2018[5]. The EU Taxonomy will be used as the basis for many aspects of the EU Action Plan[6], such as devising a standard for green bonds, ECO labels for sustainable funds and gauging how much of a company's overall turnover actually comprises sustainable activities. While the EU Taxonomy is voluntary, it is expected to have a lot of buy-in from market participants. The aim is, by giving companies and financial instruments readily comparable sustainability credentials, to open the market up to a much broader range of potential participants.

Whether an economic activity qualifies as being environmentally sustainable depends on the following technical screening criteria:

1. the activity must contribute substantially to one of the six EU environmental objectives[7];

2. the activity must not cause significant harm to any of the EU environmental objectives;

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5 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-feedback-and-workshops_en.pdf

6 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN

7 The six EU environmental objectives are: 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; and protection of healthy ecosystems.

3. the activity must comply with minimum social safeguards; and

4. the activity must comply with technical screening criteria.

When it comes to defining which activities are compliant with the EU Taxonomy, the TEG takes into account existing EU legislation and has based its work on NACE codes[8], which are EU statistical classifications of economic activities. However, these have been criticised in some areas as not being the right tool for the job. In addition, the NACE codes only cover the EU economy, but the financial industry often operates on a global level. Therefore, some market participants believe the TEG should align its taxonomy to other international classification systems, such as ICB[9] or GICS[10].

Another concern is that the EU Taxonomy should not be so restrictive that it makes reporting so unmanageable that financial institutions avoid lending or are so restrictive that they prevent transitioning entities from accessing funding to further finance their ESG transition[11]. The EU Taxonomy's aim is to serve as a dictionary rather than a mandatory list. Its purpose is to help market participants establish a common language about which activities are sustainable and reduce concerns about greenwashing. However, the use of the EU Taxonomy will be voluntary.

ECO Labelling and the EU Taxonomy

One notable barrier facing ESG and sustainable investing is its labelling. The EU Taxonomy may be used to assess which proportion of a company's production revenues are compliant with it. For example, a solar farm operator would likely receive a 100 per cent. 'greenness' evaluation as all of its revenue comes from a 'green' activity, whereas a company that produces electricity by coal and solar would receive a lower green assessment. An EU sustainable finance ECO label, together with the EU Taxonomy, will set the percentage thresholds a fund needs to fulfil in order to be compliant, and the minimum ESG practices a company has to comply with. A fund would be deemed 'green' or 'environmentally sustainable' when the overall proportion of the green activities of its holdings that are compliant with the EU Taxonomy are higher than a certain threshold. For example, one fund would be attributed a 60 per cent. sustainable activities weighting, while the second one, only 20 per cent. thereby making an investor's investment selection more transparent and therefore easier.

The EU GBS and the EU Prospectus Regulation

The EU GBS[12] will include guidance or options on a green bond standard. The EU GBS will be linked to the EU Taxonomy when determining what qualifies as a green bond. However, the use of the EU Taxonomy will be voluntary.

Currently, when an issuer considers a green bond issuance, neither Regulation (EC) No. 809/2004, nor its forthcoming successor, Regulation (EU) 2017/1129, (the "**New Prospectus Regulation**") requires the issuer to provide specific information in the prospectus on the extent to which the issuance serves a 'green' purpose. Under current regulations, the prospectus need only contain information that enables investors to make an informed assessment of the securities offered by an issuer. While the 'green use of proceeds' by green bond issuers is the hallmark for ESG investors, most other ESG information is provided by issuers to investors outside the prospectus. For instance, green bonds will be marketed to investors as 'green' during road shows but some issuers do not include information within the prospectus to explain why such bonds can be labelled as 'green'. Consequently, there is currently no EU regulatory requirement on issuers to continue applying green standards or providing periodic reporting or verification by a third party at any time after issuance[13]. Some regulators believe that the absence of mandatory regulation for the provision of information in the prospectus increases the risks of 'greenwashing' and would prefer to have a clear legal basis under the

[8] https://tl9000.org/abcb/nace.html

[9] https://www.ftserussell.com/financial-data/industry-classification-benchmark-icb

[10] https://www.msci.com/gics

[11] Commentators have noted that transitioning entities will have the greatest impact on reducing overall carbon footprint than those who are already sustainable.

[12] EU GBS working group is to report on the proposed GBS by Q2 2019.

[13] There is no 'greenium' or pricing advantage for most green bonds and both reputation and misrepresentation are felt to be enough of a deterrent against 'greenwashing'.

Prospectus Regulation to require issuers to ensure green bonds remain green during their life and require issuers to communicate this information regularly to investors. They recommend the EU GBS include a building block information annex on green bonds under the New Prospectus Regulation.

Low Carbon Index and the EU Benchmark Regulation the ("EU BMR")

Sustainable indices and funds are becoming increasingly prolific, and whether a company's investment opportunities are eligible for investment via a sustainable fund or inclusion on a sustainable index could impact their share price or cost of debt funding. As part of the EU Action Plan, on 25 February 2019, the EU Parliament and the Council reached a political agreement on the creation of two new categories of benchmarks: the 'EU climate transition benchmark'[14] and the 'EU Paris-aligned benchmark'[15]. The EU BMR will be updated through delegated acts to take account specifically of these two new low carbon benchmarks[16]. The proposed amendment would introduce and define low-carbon benchmarks as a new class of benchmark, for which administrators must explain their methodology regarding the measurement and reconciliation of ESG or low-carbon factors in their index. The Commission will also have the power to set minimum standards for classification as a low-carbon benchmark to prevent users of benchmarks being misled by false or exaggerated nomenclature.

EU Action Plan and Investment Advisors/ Managers

The intention of the EU Action Plan is that better disclosure will lead to greater and more comparable information on sustainability risks, thereby resulting in more and better investment opportunities for investors.[17] The EU Action Plan will provide a framework for transparency across the sustainable finance space where issuers, managers and funds will demonstrate the sustainability of their product or service in a transparent way for investors. Under the EU Action Plan, institutional investors including asset managers, insurers and pension funds will need to report to clients or stakeholders on how they integrate sustainable and ESG risks into their investment processes. Entities marketing financial products as sustainable investments will need to publish details about the sustainability impact of those investments, along with targets and the methodologies used to quantify them. These new disclosure requirements[18] will be in addition to existing regulatory reporting requirements contained in the Undertakings for Collective Investments in Transferable Securities ("**UCITS**") Directive and the Alternative Investment Fund Managers Directive ("**AIFMD**").[19] The EU Action Plan will require amendments through delegated acts to the Markets in Financial Instruments Directive II ("**MiFID II**") and the Insurance Distribution Directive ("**IDD**").

MiFID II

As part of the EU Action Plan, the European Securities and Markets Authority ("**ESMA**") published a consultation paper[20] setting out proposals requiring the integration of sustainability risks into investment decisions or advisory processes under MiFID II, which was followed by a draft Delegated Regulation from the Commission in January 2019[21]. Given that under MiFID II, in-scope firms must establish adequate procedures to ensure compliance with MiFID II obligations, this amendment means such firms would need to devise a procedure to at least assess the sustainability of investments and processes it advises on. Similarly, ESMA's guidelines on MiFID II will be updated to refer to the need to identify with a relevant degree of granularity a particular client's ESG preferences with regard to their investments.

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14 Where the underlying assets have less carbon emissions than a standard index.

15 Where carbon emission savings exceed their carbon emissions with the aim to meet the two degrees Celsius objective in the Paris Agreement.

16 https://ec.europa.eu/transparency/regdoc/rep/1/2018/EN/COM-2018-355-F1-EN-MAIN-PART-1.PDF

17 http://europa.eu/rapid/press-release_IP-18-3729_en.htm

18 Pension funds and asset managers have warned against the criteria being too prescriptive, as different organisations will have their own ESG and sustainable investment processes.

19 https://www.ipe.com/analysis/analysis/esg-european-commission-triggers-unease-with-esg-approach/10023420.article

20 https://www.esma.europa.eu/press-news/consultations/consultation-integrating-sustainability-risks-and-factors-in-mifid-ii

21 http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-act-2018_en.pdf

It is unlikely that wholesale bonds, for which the target market is exclusively wholesale investors, would have to disclose a separate ESG analysis of the issuance, given that institutional investors are deemed to have sufficient experience to judge whether bonds meet their ESG preferences. Asset managers, however, may have to undergo additional engagement with their clients to ensure their ESG preferences are known and accounted for.

UCITS and AIFMD

ESMA is consulting on the inclusion of similar considerations for fund managers outside of the scope of MiFID II through amendments to the UCITS Directive and the AIFMD[22], following a regulatory proposal from the Commission[23]. All in-scope fund managers, including insurance and pension funds, would need to incorporate sustainability risks –i.e. the risks of fluctuation in the value of positions in a fund's portfolio due to ESG factors– into their decision-making processes, which increases the value of sustainability and long-term thinking. Fund managers would need to disclose how they integrate ESG risks in investment decisions and fund managers will need to disclose their methodologies used to measure the ESG impact of an investment or product, but they will not have to disclose all details of their investment strategy.

The EU Directive on Disclosure of Non-Financial Information[24] (the "EU NFI Directive")

Separate from the EU Action Plan, the new regulations in the EU NFI Directive require in-scope companies[25] to disclose, to the extent necessary for an understanding of the company's development, performance, position and impact of its activity, information relating to: environmental; employee; social; human rights; anti-corruption; and anti-bribery matters. This includes a description of:

- the company's business model;
- the company's ESG policies, including any due diligence processes implemented pursuant to those policies;
- the outcome of those policies;
- the principal risks relating to ESG matters in connection with the company's operations;
- how the company manages ESG risks; and
- a description of the company's business relationships, products and services which are likely to cause adverse impacts relating to ESG risks.

Credit Ratings and ESG Disclosure

Credit rating agencies ("**CRAs**") offer issuers sustainability ratings as indicators to ESG investors. These ratings are distinct from an issuer's general credit rating, because they evaluate the overall sustainability quality more objectively. This may be set to change, as some CRAs have stated that ESG factors, including the steps issuers are taking to transition to a low carbon economy, are being incorporated into general credit ratings –i.e. those that make a direct impact on the issuer's cost of financing. Issuers' sustainability and exposure to unsustainable activities will be increasingly significant in this regard, as the availability of data makes the scale of macro-economic, climate-related risks more quantifiable and transparent. An ESMA consultation paper[26] proposes a new requirement that ratings disclose whether and how ESG criteria have been considered as part of a credit assessment outlook. It also proposes a requirement to include a reference and link to the relevant section of the CRA's website where ESG material can be found or provide a document

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22 https://www.esma.europa.eu/sites/default/files/library/esma34-45-569_consultation_paper_on_integrating_sustainability_risks_and_factors_in_the_ucits_directive_and_aifmd.pdf

23 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018PC0354&from=EN

24 https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0095&from=EN

25 Large undertakings which are public-interest entities exceeding on their balance sheet dates the criterion of the average number of 500 employees during the financial year.

26 https://www.esma.europa.eu/press-news/consultations/consulation-disclosure-requirements-applicable-credit-ratings

explaining how ESG factors were considered within the credit rating methodologies. However, this consultation paper does not create a new liability regime for CRAs.

Sustainable Structured Finance and the EU Action Plan

Though the simple, transparent and standardised framework ("**STS**")[27] does not specifically refer to green assets, EU leaders having signalled their intent to use STS and other sustainable structured finance products to help fulfil EU obligations under COP 21. Transitioning the EU to a sustainable economy as envisaged by COP 21 will require an enormous investment in sustainable infrastructure. The amount of capital needed to meet the challenge is so large that banks alone cannot finance this required investment. Fortunately, there is a deep pool of capital in the hands of institutional investors who are the key participants in the USD 100 trillion bond market. Sustainable securitisation and financial aggregation techniques as supported by the EU Action Plan can help achieve this objective. Sustainable covered bonds and sustainable securitisation initiatives (e.g. green mortgage and asset-backed securities), STS and sustainable Collateralised Loan Obligations ("**CLOs**") will have a legislative framework through the EU Action Plan and can be used to turn, for example, sustainable infrastructure loans into a liquid asset class connected to the bond markets. The transfer of sustainable loans from bank balance sheets into sustainable CLOs will replenish bank sustainable lending capacity. Sustainable securitisations, covered bonds and other types of structured products can help drive the EU economy to meet the EU sustainable growth needs.

Securitisation and its capacity to pool individually illiquid assets (energy-friendly building mortgages, electric vehicles loans, wind farm loans, etc.) into bond market securities creates an opportunity to scale sustainable finance[28]. The opportunity sustainable securitisation offers to sustainable finance in the EU is three-fold by:

- allowing product originators to scale assets to a level they find economically viable;
- providing a larger number of investable sustainable assets to meet demand from EU investors[29]; and
- permitting more risk distribution and diversification of funding sources thereby freeing up capital for institutions to use for other sustainable lending activities[30].

The EU Action Plan solves many of the challenges that previously prevented the EU sustainable structured finance market from scaling up by:

- introducing ECO labelling;
- providing benchmarking opportunities on a sustainable index;
- defining clear standards through the EU Taxonomy and providing for CRA-focussed assessment processes for sustainable assets; and
- integrating an ESG assessment (including through non-financial reporting legislation) metrics across assets types.

Regulatory Relief and Incentivisation

Current EU regulations do not discriminate between "green" investments and "brown" investments (those potentially associated with unsustainable practices). The Commission is exploring the feasibility of certain regulatory measures to propagate the sustainable finance market. While not currently part of the EU Action Plan, the 'green supporting factor' is one such proposal. This is a multiple applied to banks' capital risk-weightings to reduce the relative weighting of sustainable assets. Other proposed measures include a 'brown penalising factor' –higher capital requirements for carbon-intensive assets. Such a provision would avoid the concern of lowering capital requirements while still giving a political signal in favour of sustainable finance.

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27 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/securitisation_en#new- rules-for-simple-and-transparent-securitisation

28 See further about sustainability-linked loans: https://www.whitecase.com/publications/alert/it-pays-be-sustainable-new-cornerstone-green-revolution.

29 Since investor demand is expected to increase now that ESG will be at the heart of investment advice under the EU Action Plan (see *Investment Advisors/ Managers* section above).

30 http://unepinquiry.org/wp-content/uploads/2018/12/Towards_a_sustainable_infrastructure_securitisation_market.pdf

The current prevailing market view suggests that a green supporting factor would be problematic and difficult to justify from a prudential view, while higher risk weightings for brown assets is the preferred option as it should discourage lending for activities that have a negative climate, environmental or social impact. This means incorporating climate risks into banks' risk management policies. Once you have the taxonomy in place, the question is how to reward the green and penalise the brown. Some of the incentives must necessarily be led by governments or policymakers. Others, such as pension funds considering phasing out coal investments, lead to their own set of questions. For example, who would track this and should the policymakers or investors set the compliance timeline? There are other incentives being considered ranging from tax discounts to third party service provider rebates for issuers but the feasibility and implementation details still need to be worked out. Some Central Banks have raised the need for market participants to start quantifying and disclosing their exposure to environmental risks and are looking to the components of the EU Action Plan alongside the additional recommendations by the Task Force on Climate-related Financial Disclosures[31] to introduce a harmonised package of sustainable finance tools across the EU.

The Future of EU Sustainable Finance Regulation

The consensus is that growing the sustainable finance market will be beneficial to the planet and to financial market participants in all capacities. According to the United Nations Environment Programme[32] , having a more circular economy[33] and reducing natural resource consumption by 15 per cent. could add around 7 per cent. to the GDP of the G20 countries, and could cut greenhouse gas emissions by 60 per cent. - which would surpass what is required by COP 21. However, the present lack of clear definitions of what constitutes a sustainable investment is often-cited as the reason for some market participants being reticent in engaging with this sector and if incentives or 'greeniums' start to affect pricing or yield in the sustainable finance market, clear parameters must be set to avoid such incentives being abused. To be most effective, a careful balancing act must be taken to avoid restricting the market so it can grow from a relatively niche to a more robust mainstream market and become an effective tool to help achieve EU goals on sustainability.

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31 https://www.fsb-tcfd.org/

32 See further information in the G20 White paper on sustainable CLOs White & Case co-authored: https://www.unenvironment.org/

33 http://www.eib.org/attachments/thematic/circular_economy_guide_en.pdf

Our EMEA Capital Markets Sustainable Finance Practice

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