EU Sustainable Finance Regulations: 2021 and Beyond

Dr. Michael Huertas
Partner, Co-Head Financial Institutions Regulatory Europe at Dentons

Ciara Horigan
Regulatory & Government Affairs, State Street — EMEA

Carlo M. Funk
Head of ESG Investment Strategy, State Street Global Advisors — EMEA

This piece provides an overview of key developments in the European Union’s (EU’s) Sustainable Finance Agenda that will play out in 2021 and beyond, including the implications of the European Green Deal and the Renewed Sustainable Finance Strategy for financial market participants and financial advisors. The European Central Bank’s (ECB’s) efforts on ESG will be discussed, and in particular, what Banking Union Supervised Institutions should consider in relation to the new compliance challenges. Finally, we provide details of a proposal for potential new regulatory requirements for ESG data providers.

Summary

- The European Green Deal and its legislative instruments will reshape the financial services landscape in Europe and potentially beyond. It is therefore being closely monitored globally.

- SFDR comes into effect in March 2021, but some details remain unclear regarding practical implementation.

- The ECB is accelerating its efforts to push the ESG agenda.

- Discussions around regulation of ESG data providers are emerging.
Background: What the EU Considers as Sustainable Finance

As the executive branch of the EU, the European Commission (EC) has set two broad overarching sustainability principles.

The first is to increase investment in longer-term and sustainable activities and transform Europe's economy into a greener, more resilient and circular system. This involves reducing pressures on the environment, addressing greenhouse gas emissions and tackling pollution, and minimising waste and improving efficiency in the use of natural resources. The EC has demonstrated leadership on this through its plan to issue €225 billion of green bonds as part of the Next Generation EU (NGEU) programme.

The second principle is to provide transparency on the risks that may have an impact on the sustainability of the financial system.

European Green Deal Key Priorities

With this in mind, what are the EC's key priorities for its Green Deal in 2021?

The EC set out the European Green Deal on 11 December 2019 as a roadmap for a transition to a sustainable finance-minded EU economy, to meet the Paris Agreement Goals and to create a circular economy. The European Green Deal includes a sustainable finance taxonomy that will allow the EC to define what financial activities can be classified as 'green'. The aim is for the transition to a sustainable low-carbon economy to occur in a just and equitable manner that considers all stakeholders.

As the legislative policymaking body of the EU, the EC has taken the lead to propose legislative pillars. The legislative rule making progress in its early stages, although is progressing at a rapid pace. Further rulemaking is on its way — notably through proposals on standards to ESG Data Providers. Along with the EC's legislative policymaking efforts, there are also similar efforts from individual EU-level authorities and industry associations.

The European Green Deal sits as an overarching effort to that of the Capital Markets Union (re-launched in September 2020 as CMU 2.0) in aiming to create a single EU capital market, as well as the 2018-launched Energy Union.
If the European Green Deal can be thought of as the aim to move to a more sustainable future, the legislative instruments are the building blocks to get us there.

The three key building blocks of the EU’s legislative efforts are:

1. **Sustainability in Financial Services Disclosure Regulation (SFDR)**, which aims to improve transparency across the financial services ecosystem as to how and where sustainability risks are factored into investment decisions. Enters into force on 10 March 2021.

2. **New Low Carbon Benchmarks Regulation** governing the provision and use of climate benchmarks in the EU. These include the Climate Transition Benchmarks (CTB) and Paris-Aligned Benchmarks (PAB). ESMA relief for benchmark administrators’ disclosures expired on 23 Dec 2020; administrators must endeavour to develop at least one climate benchmark by 2022.

3. **Taxonomy Regulation** is the cornerstone of the EU’s approach to sustainable finance, and aims to define a unified classification system for sustainable economic activities. Full application from 1 January 2023.

The EC is expected to launch a Renewed Sustainable Finance Strategy in March to further policy initiatives outlined in its 2018 Action Plan on Sustainable Finance. In addition, we expect the EU to ‘export’ its environmental values to other jurisdictions, for example via the upcoming EU-Africa Summit and its new International Platform for Sustainable Finance.

Supplementing these legislative measures is the various industry-led efforts such as the ongoing work around a Green Bond Standard and the Loan Market Association (LMA) standards to create a glossary of terms applicable to green bonds and sustainable lending transactions. Labels and standards is also expected to feature prominently in the Renewed Strategy.

Equally important are ongoing international efforts to coalesce around common sustainability reporting standards, with the Sustainability Accounting Standards Board (SASB) and other standard setters, forming a coalition to align standards. Meanwhile, the International Financial Reporting Standards (IFRS) Foundation will build on those existing sustainability standards and the work of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD), which may be complemented by efforts of the International Organisation of Securities Commissions (IOSCO).

Financing and supervision will also be key from the ECB and European Banking Authority, as discussed later.
The timeline below shows the key regulatory milestones as part of the EU Green Deal. All of the elements will feed into the EC's Renewed Strategy, which we expect to be published in March 2021.

<table>
<thead>
<tr>
<th>Key Dates</th>
<th>2020 End 2020: Taxonomy</th>
<th>Delegated acts on climate change mitigation/adaption activities to be published (with a view to it applying from 1 January 2022), but deadline missed, now exp. early Jan 2021</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>23 Dec 2021: Climate Benchmarks</td>
<td>Three final sets of min standards for ‘Low carbon' benchmarks published</td>
</tr>
<tr>
<td></td>
<td>2021 End Jan 2021: SFDR RTS</td>
<td>ESAs to deliver final draft RTS to the EU Commission</td>
</tr>
<tr>
<td></td>
<td>3 Feb 2021: EBA Climate Risk</td>
<td>EBA consultation on management &amp; supervision of climate risks closes</td>
</tr>
<tr>
<td></td>
<td>8 Feb 2021: Corporate Governance</td>
<td>EC consultation on sustainable corporate governance closes.</td>
</tr>
<tr>
<td></td>
<td>8 Feb 2021: Marketing ESG</td>
<td>ESMA consultation on marketing guidelines under the cross-border distribution directive closes (greenwashing)</td>
</tr>
<tr>
<td></td>
<td>Mar 2021: Renewed Sustainable Finance Strategy</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10 Mar 2021: SFDR Website &amp; Prospectus Disclosures</td>
<td>Narratives on sustainability risk integration; ESG funds (Art 8; 9): detailed narratives; Detailed narratives on targets and measurement</td>
</tr>
<tr>
<td></td>
<td>Q2 2021: Taxonomy</td>
<td>EC to adopt delegated regulation on taxonomy-related disclosures by undertakings reporting non-financial information supplementing the Taxonomy Regulation (Article 8)</td>
</tr>
<tr>
<td></td>
<td>Mid 2021: NFRD Review</td>
<td>Expected publication of legislative proposals to amend NFRD</td>
</tr>
<tr>
<td></td>
<td>30 Jun 2021: SFDR Website (PAI)</td>
<td>Principal Adverse Impact statement</td>
</tr>
<tr>
<td></td>
<td>Aug 2021: Marketing ESG</td>
<td>ESMA to submit final report to the EU Commission</td>
</tr>
<tr>
<td></td>
<td>Nov 2021: UN Climate Change Conference (COP26)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>26 Dec 2021: Prudential</td>
<td>EBA to submit reports to co-legislators relating to ESG issues — impact on MiFID investment firms incl IFR/IFD firms</td>
</tr>
<tr>
<td></td>
<td>2022 1 Jan 2022: SFDR Annual Reports</td>
<td>Mainly Article 8 &amp; 9 disclosures</td>
</tr>
<tr>
<td></td>
<td>1 Jan 2022: SFDR Prospectuses</td>
<td>ESG funds: taxonomy — Objectives pursued and targeted alignment — narrative and graphical representation</td>
</tr>
<tr>
<td></td>
<td>1 Jan 2022: Marketing ESG</td>
<td>First set of Technical Screening Criteria due to apply</td>
</tr>
</tbody>
</table>
Some key milestones are highlighted below:

- There is increasing attention on sustainable corporate governance and minimising greenwashing through strict marketing guidelines from February 2021.
- The various transparency obligations of the SFDR will be in place on 10 March 2021, with full application from 2022.
- Corporate sustainability reporting requirements will be enacted through the Non-Financial Reporting Directive from mid-2021.
- The European Banking Authority will publish its work on the prudential treatment of sustainability risks in December 2021.
- The Taxonomy screening criteria disclosures apply from the end of 2021, before becoming fully applicable at the start of 2023.

SFDR defines sustainable investments as an economic activity that contributes to a particular environmental or social objective. Under SFDR, there are requirements around negative environmental, social and governance (ESG) impacts, particularly with respect to human rights, and anti-corruption and anti-bribery rules. Sustainability-related risks are recognised as having a potential material impact on the value of an investment. SFDR also specifies governance requirements for investee companies.

SFDR contains transparency rules that relate to financial products and a wide range of financial market participants and financial advisors. It introduces entity-level (e.g. company websites) and product-level disclosure requirements of how sustainability risks and factors are considered in the investment process. There are enhanced transparency requirements for so-called Article 8 and 9 products, which promote ESG characteristics or, essentially, a specific ESG outcome. The European Supervisory Authorities (ESAs) have proposed mandatory reporting templates and a prescriptive set of principle adverse impact indicators.
The table provides a summary of the key SFDR requirements:

### Figure 2
**SFDR: Investors’ Duties and Disclosures**

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Financial Market Participant</th>
<th>Financial Adviser</th>
<th>Type of Financial Product</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Website Disclosures</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sustainability risk policies (Article 3)</td>
<td>Y</td>
<td>Y</td>
<td>All (within scope of the SFDR).</td>
</tr>
<tr>
<td>Adverse sustainability impacts (Article 4)</td>
<td>Y</td>
<td>Y</td>
<td>All</td>
</tr>
<tr>
<td>Remuneration policies (Article 5)</td>
<td>Y</td>
<td>Y</td>
<td>All</td>
</tr>
<tr>
<td>Promoting environmental or social characteristics or sustainable investments (Article 10)</td>
<td>Y</td>
<td>N</td>
<td>Financial product that promotes environmental or social characteristics.</td>
</tr>
<tr>
<td><strong>Pre-Contractual Disclosures</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sustainability risks (Article 6)</td>
<td>Y</td>
<td>Y</td>
<td>All</td>
</tr>
<tr>
<td>Adverse sustainability impacts (Article 7)</td>
<td>Y</td>
<td>N</td>
<td>All</td>
</tr>
<tr>
<td>Promoting environmental or social characteristics (Article 8)</td>
<td>Y</td>
<td>N</td>
<td>Financial product that promotes environmental or social characteristics.</td>
</tr>
<tr>
<td>Sustainable investments (Article 9)</td>
<td>Y</td>
<td>N</td>
<td>Financial product that pursues sustainability objectives.</td>
</tr>
<tr>
<td><strong>Periodic Reports</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Promoting environmental or social characteristics or sustainable investments (Article 11)</td>
<td>Y</td>
<td>N</td>
<td>Financial product that promotes environmental or social characteristics.</td>
</tr>
</tbody>
</table>

Source: Dentons, January 2021.

In practice, at the entity level, financial market participants and financial advisors must make available a statement on the integration of sustainability risks and a statement on adverse sustainability impacts on their websites. In addition, they will have to show how their remuneration policies are commensurate with their sustainability objectives. Financial market participants will further have to state on their websites how their environmental and social characteristics impact on sustainable investments.

Furthermore, SFDR requires disclosures in pre-contractual documentation with regards to sustainability risks, adverse sustainability impacts, with enhanced requirements for products that either promote ESG characteristics or pursue sustainability objectives. Although the requirements enter into force on 10 March 2021, the ESAs have not been able to deliver final technical standards by the end-2020 deadline. Instead this is expected to be submitted to the EC for adoption by end-January 2021.

This means that FMPs only have a matter of weeks to assess final requirements, hence the ESA’s Chair requested a delay to the overall regime. However, the EC chose to retain the overall level 1 deadline, allowing FMPs to comply with the disclosure requirement in a high-level manner, while the more detailed level 2 requirements will apply at a later stage — although not explicitly stated, it is widely expected that this will be 1 January 2022, in line with the Taxonomy Regulation.
In January 2021, the chair of the ESAs wrote a letter to the EC highlighting several areas of uncertainty with respect to interpreting certain elements of SFDR, which have been voiced by FMPs and require urgent clarification in order to facilitate compliance with SFDR on 10 March 2021. These are listed below:

- The application of SFDR to non-EU Alternative Investment Fund Managers (AIFMs) and registered AIFMs
- Application of the 500-employee threshold for principal adverse impact reporting on parent undertakings of a large group
- The meaning of “promotion” in the context of products promoting environmental or social characteristics (including whether a product must apply a minimum share of such investments to qualify under Article 8)
- The application of Article 9 of SFDR (including the use of an EU Climate Transition Benchmark or EU Paris-aligned Benchmark)
- The application of SFDR product rules to the Markets in Financial Instruments Directive (MiFID) portfolios and tailored funds (including concerns around confidentiality requirements)

How might global sustainability efforts be impacted by those of the EU?

Sustainable finance and hardwiring the EU Green Deal is at the heart of many of the discussions around Europe’s economy, particularly in the wake of the COVID-19 pandemic. As an indication, the European Investment Bank (EIB) has allocated €1 trillion for a green financing package. While green finance and ESG investing is increasing post-pandemic, there is recognition that more needs to be done, which is implicit in the ongoing regulatory efforts in the European Union.

In the US, President Biden has reversed the tone of the previous administration in committing to tackle climate change and re-joining the Paris Agreement — something very much welcomed by the EU. President Biden’s ‘Green New Deal’ shares conceptual similarities to the EU’s efforts around Carbon Border Taxes to prevent offloading from companies in countries with laxer environmental rules.

We expect synergy effects notably if the EU and US create a carbon trade zone. Members of the European Parliament are already considering groundwork for a Transatlantic Green Deal, as part of the EU outreach strategy to the Biden Presidency (details of which were published in Q4 2020).

The ECB has three broad functions: a financial stability/oversight function, a monetary policy function and a supervisory function of Euro-area banks. Since 2016, green finance has been at the centre of the major thematic developments in sustainable finance at the ECB and a specific focus under ECB President Christine Lagarde.

The following figure illustrates the ECB’s efforts on Sustainable Finance.
The blue boxes show where the ECB is driving change through its own supervisory expectations of banks and its ability as a rulemaker to formulate guides, rules and recommendations. The aim has been to formulate an institutional response to the EU’s legislative reforms while also driving Capital Markets Union (highlighted in green above). Under this holistic approach, the Green Deal and Capital Market Union are interrelated; each requires the other to be fulfilled. While the ECB’s efforts have a direct impact on primarily banking groups and certain investment firms, they also cascade through those affected firms dealings with the wider market.

What do Banking Union Supervised Institutions need to consider regarding the new compliance challenges?

1. **Financial stability — ESG is now a financial stability risk and an ECB priority** There is consensus that medium-term risks may emerge for banks heavily exposed to sectors with high-carbon emissions. There is a supervisory expectation that banks need to decouple from the carbon economy but do so in a way that is just and equitable, and managed to ease away from the carbon economy at a sustained pace.

2. **Monetary policy — e.g. Purchases of Green Bonds or acceptance as collateral is becoming commonplace** No consistent premium for Green Bonds, while banks keep increasing their share of green assets.

3. **Economic analysis — The ECB’s last Annual Financial Stability Review (published in November 2020) highlights the economic case for tackling sustainability challenges now** There is emphasis on ensuring that the green transition is embedded as a core component of COVID-19 economic recovery efforts.
4 Banking Union supervision — Final Guide on Climate-related and Environmental Risks published in November 2020 and developed jointly by ECB and national supervisors. It sets out ECB’s supervisory expectations, including what institutions are expected to do.

The Guide is not legally binding on institutions but sets supervisory expectations that serve as a basis for supervisory dialogue including as part of the Supervisory Review and Evaluation Process (SREP), which, in turn, is binding on directly ECB-SSM (Single Supervisory Mechanism)-supervised institutions. Therefore, while the Guides are not legally binding agreements, they can essentially be treated as rules, and so quasi-legally binding. Direct ECB-SSM supervised institutions will need to perform self-assessment against ECB expectations in 2021. The ECB-SSM will full review practices in 2022. The ECB’s next supervisory stress-test in 2022 will focus on climate-related risks. As with other ECB Guides, it is likely that Guide will be rolled out to ECB-SSM indirect supervised institutions.

We also expect some harmonisation between the efforts of the ECB and those of the European Banking Authority (EBA), as the EBA has published its own EU-wide supervisory expectations and principles. Therefore, Banking Union Supervised Institutions need to account for and comply with multiple rules ahead of greater regulatory harmonisation.

The EBA public consultation cites State Street’s R-Factor, in relation to SASB, as an example of an approach being undertaken in the management of climate and wider ESG-related risks. This is part of the EBA’s exposure method, whereby institutions assess how individual exposures and clients perform in terms of ESG risks (usually based on scores/ratings).

High-quality ESG data is critical for investors to successfully integrate ESG considerations into portfolios and conduct effective stewardship of assets. The Dutch and French financial market supervisory authorities have proposed a European regulatory framework for providers of sustainability-related data services that could become one of the key measures of the European Commission’s Renewed Sustainable Finance Strategy.

The proposal aims to avert certain risks for investors, specifically to prevent misallocation of investments, and greenwashing, and ensure investor protection by including requirements on transparency on methodologies, management of conflicts of interest, internal control processes and enhanced dialogue with companies subject to sustainability ratings.

The proposal is to create an EU Regulation that entrusts supervision of ESG data providers to ESMA, which is already responsible for supervising Trade Repositories and Securitisation Repositories. Such a future ESG Data Provider Regulation could introduce transparency requirements on methodologies, and on identification and management of conflicts of interest. It would provide for organisational and operational requirements to ensure robust processes for data collection and processing.

We also expect the topic of ESG ratings to feature prominently in the work of IOSCO, given it outlined ESG ratings, among other things, as a key area of focus in its April 2020 report on Sustainable Finance.

As a service provider, State Street Global Advisors is committed to fulfilling regulatory requirements in all jurisdictions in which it operates. We continue to help our clients meet their sustainability obligations and to promote the EU Green Deal objectives in a portfolio context, through integration of ESG and climate metrics across equities and bonds, and through our expertise in green bond investing. We look forward to working with clients to help them adapt to the evolving regulatory environment.
For four decades, State Street Global Advisors has served the world’s governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world’s third-largest asset manager with US $3.47 trillion* under our care.

* This figure is presented as of December 31, 2020 and includes approximately $75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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0C899741-34776061LMEAJN1 021
Exp. Date: 3/31/2022