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METHODS

The ripple effect of EU disclosures regulation in financial services sector

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The UE Disclosure Regulation 2019/2088 of November 27, 2019 on Sustainability-related Disclosures in the Financial Services Sector (known as the Disclosure Regulation, Environmental, Social and Governance (ESG) Regulation or SFDR for Sustainable Finance Disclosure Regulation) sets out general rules for classifying and reporting on sustainability and ESG criteria. Its goal is to improve transparency and disclosures. The transparency requirement concerns particular concerns, especially sustainability risks and principal adverse sustainability impacts at the financial product level. It does also concern pre-contractual disclosures. This Regulation is part of a broader legislative package under the European 'Commission's Sustainable Finance Action Plan, such as the EU Taxonomy Regulation 2020/852 of June 18, 2020.

Keywords: sustainable finance disclosure regulation (SFDR), non-financial information, sustainable investment, financial services sector, sustainable finance platform

The development of non-financial information is highly dependent on the UE taxonomy regulation's success, but its sources have different horizons, and it is part of a vast movement toward transparency for environmental, social and governance (ESG) criteria, even outside the European Union (EU).[1] The adoption of EU Regulation Sustainability-related disclosures in financial reporting: Regulation (EU) No. 2019/2088 of the European Parliament and Council of November 27, 2019 services sector,[2] which is scheduled for implementation on March 10, 2021 is a novelty on the EU side.

The G20 in order to encourage financial institutions and non-financial organizations to disclose information on climate-related risks and opportunities, the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), which was created in June 2017, has produced recommendations. Governments and banking regulators throughout the world have endorsed the following recommendations: EU Member States, Singapore, Japan, South Africa, Canada, Australia, and Hong Kong. However, the question of coercion and sanctions arises. The recent TCFD report[3] and the FCFD public consultation[4] on the financial sector show that there is insufficient data to enable the comparison of information, especially concerning GHG emissions and ITR (Implied Temperature Rise), and the benefits of Value at Risk Disclosure, which is very important in enabling banks and insurance undertakings to access risks caused by the transition to a low-carbon economy. The ITR is a new data requirement.

[1] Examples in financial markets include The London Stock Exchange's Sustainable Bond Market (SBM), launched in October 2019, the NASDAQ Sustainable Bond Network, launched in December 2019, and the UK Financial Conduct Authority (FCA).

[2] https://eur-lex.europa.eu/legal-content/FR/TXT/PDF/?uri=CELEX:32019R2088&from=FR OJEU 9 December 2019 L317/1

[3] https://www.fsb.org/wp-content/uploads/P291020-2.pdf

[4] https://www.fsb.org/wp-content/uploads/P291020-4.pdf

The general context of EU Regulation 2019/2088

This regulation is the fruit of a process carried out at unprecedented speed, bearing in mind the chances brought on by the shift to a low-carbon economy. Recital 21 of the Regulation of November 27, 2019 states that the starting point for this Regulation was an observation: Directive 2013/34/EU is not always appropriate for “direct use by financial market participants and financial advisers when dealing with end investors.”[5]

One stage: May 24, 2018

This regulation follows on from the proposed regulation of May 24, 2028 modifying the Directive of the European Parliament and Council (EU) 2016/2341COM (2018) 354 final on disclosures relating to sustainability risks and sustainable investment opportunities of May 24, 2018.[6] This proposal—the fruit of an extensive consultation with stakeholders and investors—stressed the benefits of systematically disclosing ESG risks: “leading to an optimal risk-return trade-off at least in the long-term, thereby fostering market efficiency.” [7] It is also consistent with the Communication of June 20, 2019[8], [9] on “Guidelines on non-financial reporting: Supplement on reporting climate-related information.”

Objectives

The main objective is to take sustainable development into account in a general manner and as part of a broader European Commission initiative.

The European Commission’s conclusion is clear: “it lacks a specific framework and.” Choosing a regulation as the instrument rather than a directive was an important decision, as it will enable complete harmonization between the different existing regulatory frameworks. The European Commission “is laying the foundations for a European framework that makes environmental, social and governance (ESG) criteria a centerpiece of the financial system and thereby contributes to transforming the European economy into a greener and more resilient circular system. ESG factors should be taken into account in investment decisions in order to increase sustainability.” This includes financial market participants (management companies of organizations for occupational retirement provision (IORP), managers of European venture capital funds, UCITS (undertakings for collective investment in transferable securities), alternative investment fund managers (AIF), and insurance companies (EuVECA), ESG criteria must be incorporated into internal business processes and disclosed to customers by managers of investment firms and the European Social Entrepreneurship Fund (EuSEF), who are chosen by their customers or beneficiaries to make investment decisions on their behalf.

The Commission’s package of measures is consistent with general initiatives for a more sustainable economy. Governments worldwide have chosen to embark on accepting the UN 2030 Sustainable Development Agenda and the 2016 Paris Climate Change Agreement, which will put our planet and our economy on a more sustainable course.

Areas for improvement

Areas for improvement include transparency and disclosure, monitoring the integration of ESG, clarity of investor responsibilities under the current EU regulations, data reliability and comparability, risk management, and governance structures. The duty to tender advice to institutional investors and asset managers includes the assessment of ESG-related risks and their consideration, where appropriate.

The organizations who participated in the study offered more information on topics, including investment strategy, risk management, governance measures, and particular ESG committees, members of management boards for ESG-related issues, internal audit procedures in the ESG field, engagement policy for investee companies and voting policy.

Additionally, each of them expressed concerns regarding risk management, governance, and the comparability and reliability of the accessible data structures, monitoring of ESG integration, openness and disclosure, and investor obligations in the current EU legislation.

This EU Regulation’s main accomplishment is that investors will be better informed about how to invest. When making investments, financial market participants and financial advisors consider ESG risks decisions and providing financial advice.

“By reducing the asymmetry of information between end investors and financial entities, the disclosure requirements will increase overall transparency.” Standardized regulations on transparency must be established for financial market participants and insurance intermediaries to heed this advice when offering advice on insurance-based investment products and for investment companies offering advice on such products. It necessitates, on the one hand, the incorporation of sustainability risks into the process of

[5] Recital 25 Preamble.
[6] https://eur-lex.europa.eu/legal-content/FR/TXT/PDF/?uri=CELEX:520118PC0354&from=FR
[7] Proposed Regulation 2016/2341COM (2018) 354, p. 11 “And it will ultimately increase competition, incentivizing entities to adopt high ESG standards.”
[8] https://eur-lex.europa.eu/legal-content/FR/TXT/PDF/?uri=CELEX:52019XC0620(01)&from = EN Communication 2019/C 209/01
[9] Communication of 20 June 2019, 2019/C 209/01, cited above, § 1.1.

investment decision-making or investment advise; and, on the other hand, it concerns the transparency of financial products focused on sustainable investments, including those aiming to reduce carbon emissions.

It creates new transparency rules for market participants and financial advisers.

The scope of this regulation

It concerns financial market participants and financial advisers.

Financial market participants (FMPs) (IORP) institutions include companies that provide insurance-based investment products, investment firms that provide portfolio management services, and occupational retirement provision; companies that develop pension products, managers of alternative investment funds, and companies that provide pan-European financial services. Individual retirement savings products; management businesses for undertakings for collective investment in transferrable securities, management firms for qualified venture capital funds, management firms for qualified social entrepreneurship funds, and lending institutions that provide portfolio management services.

Insurance undertakings that give insurance advice pertaining to insurance-based investment goods, insurance intermediaries that provide insurance advice relating to insurance-based investment products, and financial advisors (FAs) are all members of this category. Credit institutions that offer investment advice, investment businesses that do so, investment advice-providing AIF managers, and investment advice-providing UCITS management firms are also.

Definition of a "sustainable investment"

In a major innovation, the regulation proposes a broad, comprehensive definition of a "sustainable" investment.

Article 2(17) of the Regulation defines a sustainable investment as follows:

"an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy," or "an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labor relations, or an investment in human capital or economically or socially disadvantaged communities," with a ground-breaking condition "provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff, and tax compliance."

It also distinguishes between two types of investments. The Regulation recommends creating a "necessary" distinction between two kinds of investments for the purposes of pre-contractual disclosure and the dissemination of information in monthly reports.

Financial goods that promote social or environmental values.

Financial products "which have as an objective a positive impact on the environment and society."

Transparency of two main types of information

The disclosure obligations of directives are supplemented by this rule (UCITS, Solvency 2, AIFM, MiFID, Insurance Distribution, and Institute for Occupational Retirement Provision), and regulations (European Long-Term Investment Funds, European Venture Capital Funds). It comes under the banner of "transparency," a recurring term found in the title of many articles (integration of risks and transparency of negative impacts "in sustainability, and in the consideration of sustainability"), and of the enshrinement of an unprecedented "sustainable financial compliance" that will be the cornerstone of the effectiveness of the system, especially in order to convince the "end" investors.

The transparency requirement is apparent in many areas. It is primarily concerned with the negative consequences of sustainability and the risks of sustainability.

Transparency of policies related to sustainability risks

This transparency is the responsibility of participants in the financial markets and financial advisors.

Definition of a "sustainability risk": this is "an environmental, social or governance event or condition that, if it occurs, could cause a negative material impact on the value of the investment"; [10] (financial risk);

Disclosure medium: generalization of website use: According to Article 3 of the Regulation, these two players have a duty to act in the best interests of the end investors and "must post on their websites information about their policies on the integration of sustainability risks in their investment advice or insurance advice."

[10] §14 Preamble to Regulation 2019/2088.

Assessment of "relevant financial risks" and "relevant sustainability risks that might have a relevant material negative impact on the financial return of an investment or advice."

Transparency of principal adverse sustainability impacts

Regarding the scope of this openness, Article 4 of the Regulation makes a distinction between financial market players and financial advisers.

Financial market participants: implementation of "comply or explain"

They must publish the following information and ensure that it is kept up to date on their websites.[11]

"where they consider principal adverse impacts of investment decisions on sustainability factors, a statement on due diligence policies with respect to those impacts, taking due account of their size, the nature and scale of their activities and the types of financial products they make available";

Article 4(1)(b) of the Regulation sets out the novel implementation of "comply or explain"

"when they do not take into account adverse impacts of investment decisions on sustainability factors,"

they must publish "clear reasons for why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts."

Article 4(2) provides a list of important information such as:

(a) information about their policies on the identification and prioritization of principal adverse sustainability impacts and related indicators;
(b) a description of the principal adverse impacts and any measures taken or planned in this regard;
(c) a brief summary of engagement policies as defined in Directive 2007/36 on the exercise of certain rights of shareholders in listed companies (criteria for the selection of companies in portfolio, including financial and non-financial aspects such as ESG factors), if applicable; and
(d) a mention of their adherence to rules of responsible corporate behavior, standards for due diligence and reporting that are internationally recognized, and, if applicable, the extent of their connection with the goals of the Paris Agreement.

[11] Article 4 of the Regulation.

Participants concerned: Participants in the financial markets who employ more than 500 people and "parent firms." After June 30, 2021, financial players with at least 500 employees at the balance sheet date must publish on their website: "a statement on their due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors," which must at least include the information set out in § 2 Article 4.

Additionally, effective June 30, 2021, financial market players that are significant groupings' parent the definition of an enterprise in Article 3 of the Directive of 2013/34/EU (CSR Directive) must also publish such a statement on their websites.

Financial advisers: information that is slightly less burdensome and subject to their own appreciation

The following must be maintained and published by financial advisors on their websites:

- information as to whether, "taking due account of their size, the nature and scale of their activities and the types of financial products they advise on, they consider in their investment advice or insurance advice the principal adverse impacts on sustainability factors"; or a less burdensome form of "sustainable compliance?"
- information (no mention of "clear" as for financial market participants) "as to why they do not to consider adverse impacts of investment decisions on sustainability factors in their investment advice or insurance advice, and, where relevant, including information as to whether and when they intend to consider such adverse impacts."

Importance of future "sustainability indicators" for adverse impacts

The European Supervisory Authorities will have to draw up draught technical criteria for information presentation and content) and "sustainability indicators in relation to adverse impacts in the field of social and employee matters, respect for human rights, anticorruption and anti-bribery matters," by December 30, 2020, (a deadline that is difficult to meet in practice).

Transparency of remuneration policies in relation to the integration of sustainability risks

As evidence of the range of sustainable corporate governance, Article 5 of the Regulation mandates that participants in the financial advisors and the financial market "in their remuneration policies information on how those policies are consistent with the integration of sustainability risks, and shall publish that information on their websites."

According to sectoral regulation, financial market players and financial advisers are required to develop and maintain pay policies that contain this information.

Pre-contractual documentation: transparency of the integration of sustainability risks

A description of sustainability risks and an assessment of the effects that they are anticipated to have on the effectiveness of financial products and advice.

In their pre-contractual disclosures, financial market participants and financial advisers must "describe" the following:

- "how sustainability risks" are included into their financial choices and investment or insurance recommendations; and
- the results of the "assessment of the likely impacts of sustainability risks on the returns of the financial products they make available." [12]
- compliance in the event of the irrelevance of sustainability risks:

Where financial market participants and advisers deem "sustainability risks not to be relevant," their descriptions must incorporate "a clear and concise explanation of the reasons therefor."

Transparency of adverse sustainability impacts at the financial product level

By no later than the 30th day of December 2022, for each financial market, and financial product participants must provide[13] "a clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors." They must also provide "a statement that information on principal adverse impacts on sustainability factors" is available in the various reports (annual, periodic). [14] Technical regulatory standards can be used to "quantify" the main adverse impacts on sustainability factors. This also implies "sustainable compliance." [15]

[12] Article 6 of the above-mentioned Regulation.
[13] Article 7 (1) of the above-mentioned Regulation.
[14] The details of these reports are listed in Article 11(2) of the above-mentioned Regulation.
[15] Article 7(2) stipulates that the disclosures shall include "for each financial product a statement that the financial market participant does not consider the adverse impacts of investment decisions on sustainability factors and the reasons therefor."

Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures: ESG criteria

Where a financial product promotes "among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.", [16] the information to be disclosed must, in addition to the information disclosed pursuant to Article 6 of the Regulation, be supplemented with

- "information on how those characteristics are met";"if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics."
- Financial market participants must include "an indication of where the methodology used for the calculation of the index" can be found.

By December 30, 2020 at the latest, draft regulatory technical standards will be developed by the supervisory authorities, to specify the details of the "presentation and content of the information to be disclosed."

Transparency of sustainable financial investments in pre-contractual disclosures—a financial product with sustainable investment as its objective

Where a financial product has a sustainable investment objective and an "index has been designated as a reference benchmark," there is a requirement concerning the disclosure of information on this selected benchmark index: information is required on how the index is corresponding to this goal, together with a description of how and why this specified index is different from a wide market index. Above all, "an explanation of how that aim is to be reached" will need to be given in cases when no index has been designated as a reference benchmark index.

Specificity of a financial product aiming toward a reduction in carbon emissions

A significant innovation concerns the hypothesis of a financial product whose specific objective is "a reduction in carbon emissions": in this case, the information to be published shall include "the objective of low carbon emission

[16] Article 8 (1) of the above-mentioned Regulation.

exposure in view of achieving the longterm global warming objectives of the Paris Agreement." [17]

Generalization of websites promoting transparency of the promotion of environmental or social characteristics and of sustainable investments

The objective is the publication and updating of a series of information "for each financial product" [18], such as:

- a description of the social or environmental traits or the goal of sustainable investment;
- details on the procedures used to evaluate, quantify, and keep track of environmental and social (ES) parameters; "impact of the sustainable investments selected for the financial product." [19]
- the chosen reference benchmark index.

Focus on the quality of information and its accessibility

Not surprisingly, in line with the EU's emphasis on the quality of information for good governance and the requirement for easy access to it, these various items of information must be disclosed in an "in a way that is accurate, fair, clear, not misleading, simple and concise and in a prominent easily accessible area of the website." [20]

Transparency of the promotion of environmental or social characteristics and of sustainable investments in periodic reports

In this field, the transparency requirements are high, and their implementation is complex with regard to the assessment of the reference benchmark index chosen for a financial product.

When participants in the financial market make a financial product accessible, they must mention the different sector-specific regulations in the periodic reports. [21]

- "the extent to which environmental or social characteristics are met." [22]
- for a financial product with sustainable development as its objective, "the overall sustainability-related impact of the financial product by means of relevant sustainability indicators" or where an index has been designated as a reference benchmark, "comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators." [23]

These obligations, by way of derogation from the application of the Regulation from 10 March 10, 2021, shall apply from January 1, 2022. [24]

The scope of this publication is broad, covering AIFs, EuVECA funds, PEPPs, IORPs and insurance intermediaries, [25] managers of social entrepreneurship funds, UCITS, and others. [26]

Disclosures: updating, explanation, contradiction

Regulation 2019/2088 insists on the requirement to update and explain published information and if a financial market participant amends this information, "a clear explanation of such amendment shall be published on the same website." [27]

Furthermore, marketing communications must not "contradict" information published under the Regulation.

Finally, what is expected to facilitate the reading of this information will be the development by the Joint Committee of the European Supervisory Authorities of "implementing technical standards to determine the standard presentation of information on the promotion of environmental or social characteristics and sustainable investments." [28]

The European Supervisory Authorities will be called upon to provide an annual report by September 10, 2022 and every year thereafter, which will be made public, on the "best practices" in the Regulation, and will be able to make "recommendations" and consider the "implications of due diligence practices" on disclosures under this Regulation.

The next steps

Institutional and banking phases are already underway, which will play a crucial part in establishing the regulatory framework for sustainable financing. Others will be required to enable a "just" climate transition.

[17] Article 9 (3) of the above-mentioned Regulation.
[18] Article 10 of the above-mentioned Regulation.
[19] Article 10 (1) of the above-mentioned Regulation.
[20] Article 10 (1) (d) of the above-mentioned Regulation.
[21] Article 11 (2) of the above-mentioned Regulation.
[22] Article 11 (1) of the above-mentioned Regulation.
[23] Article 11 (1) (b) (ii) of Regulation 2019/2088.
[24] Article 20 of Regulation 2019/2088.
[25] Article 15 of Regulation 2019/2088.
[26] Article 11 of Regulation 2019/2088.
[27] Article 12 of Regulation 2019/2088.
[28] Article 13 of Regulation 2019/2088.

Technical tools

A European sustainable finance observatory: The future creation of a "European Sustainable Finance Observatory" by the European Environment Agency, in cooperation with the ESAs, which will be responsible for monitoring, reporting, and publishing information on sustainable investments by EU funds and institutions (EFSI, EIB, ECB).

A major step forward: the creation of a sustainable finance platform: This platform satisfies the wishes of the participants, especially the High Level Expert Group (HLEG). The European Commission will serve as its chair, and it will be made up of representatives from the European Investment Agency, the European Supervisory Authorities, the European Investment Bank, and the European Investment Fund, as well as specialists who represent stakeholders in the private sector. Recognized for their knowledge or proven experience. The EU Platform on Sustainable Finance, created on June 18, 2020, whose membership list[29] was published on October 26, 2020, will play a role together with the International Platform on Sustainable Finance (IPSF). This platform has a varied mission and will be essential for the future of sustainable finance (analyzing the impact of technical review criteria, tendering advice, providing analytical support, and reporting to the Commission, particularly on the "channeling of capital flows into sustainable investments."

Mobilization of the financial and banking sector

Fifty finance ministers make up the coalition of finance ministers for climate action and has adopted the "Helsinki Principles." [30]

The signal from the ECB–Christine Lagarde in her speech in London on February 27, 2020[31] "Climate change and the financial sector."

The EIB will logically become the Climate Bank – The European Investment Bank (EIB) will become the Climate Bank. The EIB, the European Union's financial arm, finances "sustainable" projects every year; but above all, it was the first to launch Green Bonds in 2017 and is actively working to finance the climate transition. Its roadmap will concern the alignment of its activities with the objectives of the Paris Agreement, and containing global warming below 2°C by the end of the century.

The banking world has taken the realized the importance of climate change, as evidenced in particular by the Network for Greening the Financial System (NGFS).

The EIB will include climate-related criteria in its decisions, which will lead it to stop financing projects, such as airport extensions, extensions of agricultural activities into natural areas, and factories with excessive fossil energy consumption.

The EIB wants to increase its proportion of climate-related financing. By 2025, this financing will need to account for at least 50% of the total amount, i.e., €30 billion annually. In total, the public bank plans to generate €1 trillion in climate investments by the end of the decade. It is expected to publish a new transport financing policy in 2021.

EU green bonds principles

The TEG Report of 18 June 2019 proposes flexible tools to implement this taxonomy in relation to the Green Bonds Standards. The aim is to allow any "organization" to indicate the percentage of its operations that significantly advance environmental goals.

COVID-19 and social bonds—climate change and social inequality[32]

Beyond this institutional aspect, the COVID-19 crisis has highlighted the need for more social finance (social bonds) to meet specific needs with a more socially oriented focus. [33] This will support a European Commission mechanism to promote a just transition. This scheme aims to finance projects to mitigate the social impact of the phasing out of fossil fuels. However, the major challenge will be to limit vulnerability and social inequality vis-à-vis climate change, with an emphasis on the need to continue along the path already actively followed within the EU.

Conclusion

I would like to conclude very briefly. Indeed, as climate change is a significant concern, ECB President Christine Lagarde highlighted in her speech for this century. "The transition to a carbon-neutral economy provides opportunities, not just risks." [34]

[29] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/eu-platform-on-sustainable-finance-members_en.pdf
[30] https://www.financeministersforclimate.org/helsinki-principles
[31] https://www.bis.org/review/r200302c.pdf
[32] https://www.un.org/esa/desa/papers/2017/wp152_2017.pdf
[33] cf. ICMA, "Green and Social Bond Principles with ICMA underline relevance of Social Bonds in addressing COVID-19 crisis and provide additional guidance" (March 31, 2020), available at https://www.icmagroup.org/News/news-in-brief/green-and-social-bond-principles-with-icma-underline-relevance-of-social-bonds-in-addressing-covid-19-crisis-and-provide-additional-guidance/
[34] Speech by Christine Lagarde, President of the European Central Bank, at the COP 26 Private Finance Agenda, London February 27, 2020.