ESG Regulation for Financial Services Companies in the European Union

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1. Introduction

By 2050, Europe aims to become the world's first climate-neutral continent. To pave the path to meet this aspiration in the fight against climate change, the European Commission (EC) released the 'Fit for 55' package, which contains ambitious climate targets. These targets set out a clear ambition for a green (and digital) transition in the EU as a whole and in individual EU member states by 2030:

- minimum 55 percent cuts in greenhouse gas (GHG) emissions by 2030, compared to 1990 levels
- above 32 percent share of renewable energy
- at least 32.5 percent improvement in energy efficiency.

The European Green Deal was always intended to be a green game changer, and on 14 July 2021, the 'Fit for 55' plan further articulated the strategy and gave traction to these transformative efforts. The 'Fit for 55' leads the way for a green transition via the use of regulations, new initiatives, amendments to key legislation and key non-legislative communications.

One of the goals is to steer private capital into sustainable business models and products. Here Financial Services Companies like banks, insurers and asset managers play an important role as investors and providers of products.

New regulations are introduced by the

- European Union (EU) > Taxonomy and Disclosure Regulation
- European Commission (EC) > Corporate Sustainability Reporting Directive (CSRD).

In addition, new standards for sustainability reporting are currently issued by

- European Financial Reporting Advisory Group (EFRAG) > EU Sustainability Reporting Standards (ESRS)
- International Sustainability Standards Board (ISSB) > IFRS Sustainability Disclosure Standards

The regulations and the standards will not only have an impact on the business of the companies itself, but also on the governance – (supervisory) boards and management boards – and auditors.

Both customers and investors have an increased demand on receiving sustainability reporting information.

2. New Regulation

2.1 European Union

Through regulation 2020/852 (Taxonomy Regulation (TR)), the EU aims to boost sustainable investments and prohibit greenwashing. The TR establishes an EU-wide classification system defining which activities are "environmentally sustainable" and how related information must be disclosed.

The TR defines six environmentally sustainable objectives: a) climate change mitigation b) climate change adaption c) sustainable use and protection of water and marine resources d) transition to a circular economy e) pollution prevention and control f) protection and restoration of biodiversity and ecosystems

For an activity to be considered environmentally sustainable, it must simultaneously

- Provide a substantial contribution to one of the six objectives by complying with technical screening criteria
- Not significantly harm any of the other objectives
- Respect internationally recognized minimum safeguards

The objective of the Taxonomy is to provide a framework for corporates to disclose to investors and customers the level of their engagement in environmentally sustainable activities and products.

The TR forsees certain disclosures both on entity/issuer level as well as at the financial product level. On an entity level, for all financial undertakings subject to NFRD (until 2023) and subject to CSRD (starting 2024) taxonomy-eligible and taxonomy eligible and aligned exposures need to be disclosed. For financial services companies specific KPI's were identified, which better fit their business. This includes percentage of eligible risk positions of total risk positions, like green asset ratio for banks.

On product level, all financial market participants offering products in the EU need to disclose taxonomy aligned exposures and qualitative information regarding sustainable investment objectives. The companies must explain, how and to what extent investments qualify as environmentally sustainable, name the environmental objectives targeted by relevant investments and compute the proportion of the portfolio's Taxonomy alignment.

Through regulation 2019/2088 (Disclosure Regulation (DR)), the EU aims to booster the disclosure of environmental related strategies, investments and products. DR and TR are interlinked.

Companies have to disclose their strategies for the inclusion of sustainable risks in their investment decisions or for the investment and product advice for customers. On the product level companies must present the percentage of non sustainable products, products with sustainable or social offerings and products including sustainable investments.

The information must be shown on the internet, in the product prospects and in regular reports.

2.2 European Commission

On April 21st, 2021 the EC published the draft of the Corporate Sustainability Reporting Directive (CSRD). This initiative has as well to be seen in context with the European Green Deal. It is one of the central instruments, to shift capital flows from companies towards sustainable investments via enhanced disclosure. It is the next step of the legislative, which was introduced by the taxonomy and disclosure regulation mentioned above and will supersede the current Non-Financial Reporting Directive. The implementation date is planned for 2024 but might be postponed to 2025.

The CSRD will have a huge impact on the strategy, the internal control systems, duties of supervisory and management boards and the incentivation.

Companies will have to issue a so-called sustainability declaration. In addition to the above-mentioned TR and DR further information about environmental, social and employee aspects including the impact on governance needs to be disclosed. This comprises the resilience of the business model and the strategy of the company towards sustainability risks, the compatibility of the company planning vis-à-vis the Paris climate goals. It has to be reported to what extent stakeholder interests and sustainability aspects are reflected in the business model and the strategy, the goals and goal achievement in relation to sustainability and measures for the prevention or improvements of negative consequences of the business conduct. The disclosure has to take place retrospective as well as prospective and both qualitative and quantitative.

An important part is the so called "double materiality". Companies have to report about aspects, which are necessary to understand their business and aspects, which are necessary to understand the impact of their business on sustainability requirements.

Companies will have to use a standard for sustainability reporting – see below. The information has to be shown in a specific section of the MD&A and must be published in digital form.

In order to improve the quality of sustainability reporting, it will have to be audited with so called "limited assurance" either by the external auditor or another auditor. Also, the supervisory board will have to monitor the reporting process and review the information like it has to do already for financial reporting.

3. (New) Standard Setters

3.1 European Financial Reporting Advisory Group (EFRAG)

EFRAG is a private association established in 2001 with the encouragement of the European Commission to serve the public interest. EFRAG extended its mission in 2022 following the new role assigned to EFRAG in the proposal for a CSRD of 21 April 2021, providing Technical Advice to the European Commission in the form of fully prepared draft EU Sustainability Reporting Standards and/or draft amendments to these Standards.

One of the proposals in the CSRD is to introduce the requirement for companies to report sustainability information based on European Sustainability Reporting Standards (ESRSs). ESRSs are to be developed by the European Financial Reporting Advisory Group (EFRAG) and adopted by the European Commission.

The CSRD, if adopted as proposed, requires EFRAG to draft, and the European Commission to finalize, an initial set of ESRSs by 31 October 2022 and further sector-specific standards by 31 October 2023.

In response, EFRAG set up various working groups to do the groundwork on the draft standards. These have now been issued formally by the newly created EFRAG Sustainability Reporting Board as exposure drafts for public consultation.

The 13 proposed ESRSs cover:

- one standard on general principles for sustainability reporting;
- one standard on overarching disclosure requirements; and
- specific disclosure requirements focused on eleven ESG topics in the area of environmental, social and governance matters.

Under the proposals, companies would have to publish separate sustainability statements as part of their management reports containing sector-agnostic, sector-specific and company-specific disclosures.

By adopting double materiality principles, the proposed ESRSs consider a wider range of stakeholders than IFRS® Sustainability Disclosure Standards (see below)

3.2 International Sustainability Standards Board (ISSB)

The IFRS Foundation is aiming to put sustainability reporting on the same footing as financial reporting by establishing a sister body to the International Accounting Standards Board (the IASB® Board). The goal is to drive globally consistent, comparable and reliable sustainability reporting using a building blocks approach. This approach will allow national and regional jurisdictions to build on that global baseline to set supplemental standards that serve their specific jurisdictional needs.

The new International Sustainability Standards Board (ISSB) will aim to develop sustainability disclosure standards that are focused on enterprise value.

New proposals on the first IFRS®Sustainability Disclosure Standards (the proposals) mark the next step towards equal prominence for sustainability and financial reporting. They are based on existing frameworks and standards, including TCFD and SASB. Their aim is to create a global baseline for investor-focused sustainability reporting that local jurisdictions can build on.

Companies would report on all relevant sustainability topics (not just on climate) under a consistent global framework and focus on how these topics impact enterprise value. Reporting would be connected to the financial statements. Therefore, companies will need processes and controls in place so that they can provide sustainability information of the same quality, and at the same time, as their financial information.

In preparation for the new board, the Foundation formed a Technical Readiness Working Group (TRWG) to create prototypes to give the new board a running start in developing its first two exposure drafts. These prototypes covered:

- General requirements for disclosure.
- Climate-related disclosures, building on the TCFD recommendations and SASB industry-based standards; and

The general requirements proposal sets the foundation

- General features of reporting, including on materiality.
- A content structure across the four areas of governance, strategy, risk management and, metrics and targets.
- Practical guidance, including on presentation of information.

The climate proposal provides additional detail

- It builds on the four content areas with additional guidance, particularly in relation to:
- disclosure of risks, climate transition plans and scenario analysis; and
- general and industry-specific metrics.

The ISSB has just released its first two exposure drafts for public comment, which build on these prototypes. There are no requirements, where the disclosure needs to take place or whether it needs to be audited.

It is the International Sustainability Standards Board's (ISSBTM) aim to create a global baseline for sustainability reporting standards that allows local standard setters to add additional requirements (building blocks), rather than face a coexistence of multiple separate frameworks.

EFRAG has published a comparison against the ISSB Board's proposals and committed to join an ISSB Board working group to drive global alignment. However, in the short term, companies and investors may potentially have to deal with three sets of sustainability reporting standards in setting up their reporting processes, controls and governance.

Key differences

- The proposed ESRSs list detailed disclosure requirements for all ESG topics. The proposed IFRS Sustainability Disclosure Standards would also require disclosure in relation to all relevant ESG topics, but the ISSB Board has to date only prepared a detailed exposure draft on climate, asking preparers to consider general requirements and other sources of information to report on other sustainability topics. The SEC focused on climate in its recent proposal.

- The proposed ESRSs are more prescriptive, and the number of disclosure requirements significantly exceeds those in the proposed IFRS Sustainability Disclosure Standards.

- While the proposed IFRS Sustainability Disclosure Standards are intended to focus on the information needs of capital markets, ESRSs also aim to address policy objectives of the EU by addressing wider stakeholder needs.

4. Impact on Governance

Reliance from the receivers of sustainability information on the correctness of the information is seen by the European Commission as an important requirement for achieving the sustainability goals. Therefor the content of the sustainability reporting has to be audited. The requirements for the review and monitoring of the board have been strengthened and national enforcement procedures shall incorporate sustainability reporting.

4.1 Boards

The enhanced sustainability reporting by the CSRD will have to be reviewed and monitored by the supervisory board, respectively by the audit committee. The monitoring requirements are not only limited to the content of the sustainability reporting, but also include the corporate governance systems. These comprise the underlying internal control, risk management, internal audit and compliance management systems. The supervisory board shall also monitor the process of digitalization of sustainability reporting. The board can use the work of the external auditor, but still keeps its own responsibility for the monitoring.

4.2 Auditors

According to CSRD the content of sustainability reporting has to be audited with "limited assurance" either by the external auditor or another independent assurance services provider. Scope of the audit is the adherence to respective European rules including an assessment on the processes and controls for the reporting process. The EU Commission is considering, moving to a "reasonable assurance" in the future.