



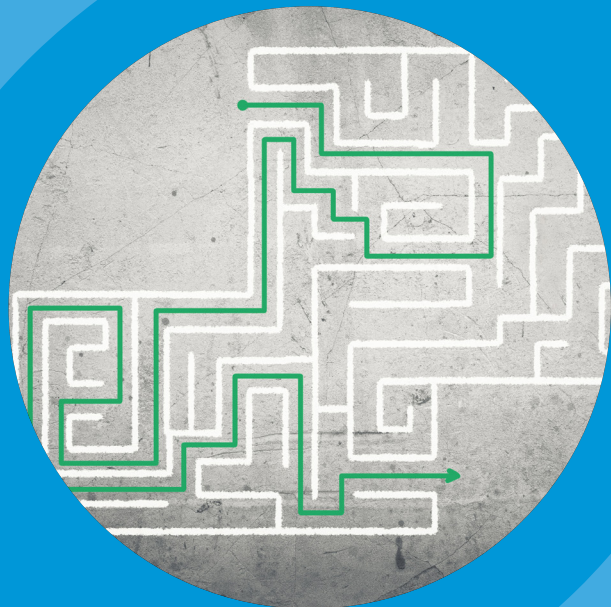
**Finance Watch**

Making finance serve society

# A guide to the next sustainable finance agenda

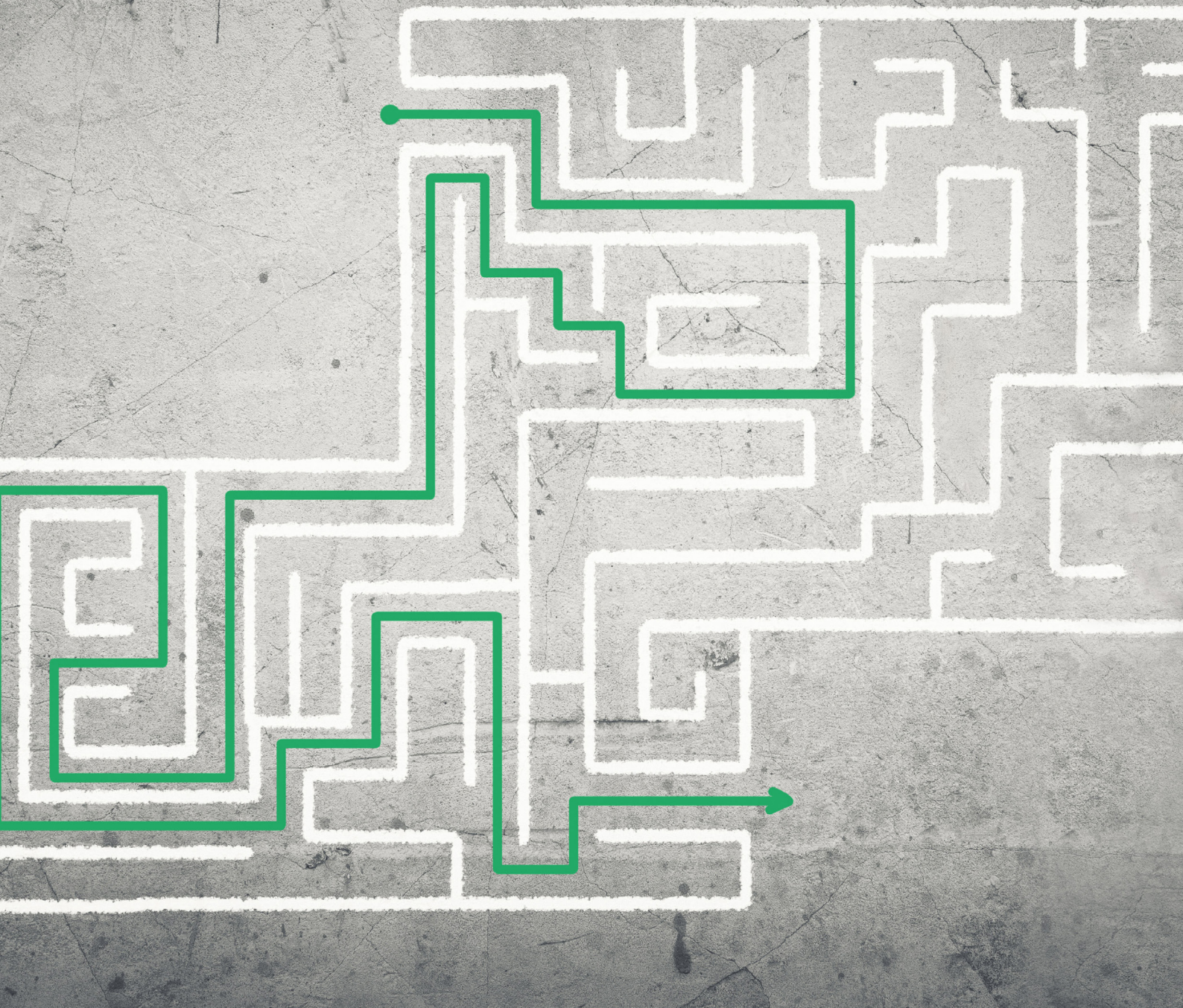
Limitations of the current framework and recommendations  
for an effective transition

A Finance Watch Report



January 2024





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## Executive summary

During the past five years, there have been significant evolutions in financial regulation, marked by the emergence of legislative acts and concepts to position finance as a catalyst for a sustainable world. As we approach the EU 2024 elections, the time has come for legislators to draw conclusions and define priorities for the next mandate.

The debate surrounding the future of the sustainable finance strategy gained importance in a context of growing criticism. Implementation inconsistencies due to delays in reaching political compromises, prioritisation of short-term performance under the assumption that companies have ample time to adapt to the consequences of climate change, as well as the current geopolitical landscape and concerns over sovereignty, have fed calls from diverse stakeholders for a regulatory pause.

Significant progress has been made for financial institutions to play a role in the transition of the real economy. Yet work towards consistent high-quality sustainability standards should be pursued to set up the necessary means to achieve a sustainable transition, define the right transition targets and ensure their adequate implementation.

Currently, transparency requirements still suffer from lack of detail, leading to heterogeneous interpretation and potentially misleading statements for consumers and investors:

- The scope of information to be reported by companies under the Corporate Sustainability Reporting Directive (CSRD) and the Taxonomy Regulation remains insufficient to identify harmful activities and integrate the social dimension, and concerns arise over the monitoring of the data quality.
- Asset managers use ESG and climate benchmarks built on inappropriate metrics to claim passive investing to be an impact investing strategy.
- Financial institutions' disclosure requirements leave too much flexibility in defining key concepts, which compromises the comparability between financial institutions, their client advice and the sustainable products they are managing.
- The flexibility in the consideration of client sustainability preferences impairs the performance of a transparent suitability test.

Sustainability-related information may be used, produced, transformed and published by different stakeholders in a way that inappropriate practices from one stakeholder can contaminate the entire chain of information. Hence, it is essential to look into each step of the information flow and bring the necessary improvements to ensure that sustainability-related information stays accurate, clear and not misleading.

Another problem is that, as shareholders' decisions remain primarily driven by short-term interest in financial returns, the level of ambitions of companies' management decreases when it comes to adopting sustainable corporate and investment practices.

Options to lengthen the time horizon for corporate decision-making should therefore also be explored.

Beyond giving the means for the financial sector to transition, legislators need to work further on the definition and achievement of meaningful targets. Today, there is still very little detail on what transition plans should look like:

- Transition tools identified by the Commission still leave loopholes that may undermine their actual contribution to the transition of the economy.
- Concrete transition targets are not sufficiently integrated in the current legislative framework.
- Legislative references to transition plans do not sufficiently specify details for disclosing transition plans and integrating them under the assurance engagements.

Finally, the current enforcement framework does not provide sufficient clarity on the responsibilities and nomination of supervisory authorities and the possible sanctions and should better integrate the work of international bodies.

This report details the above weaknesses with concrete examples while exploring the possible solutions to complete the sustainable finance agenda during the next mandate.

## Key recommendations

### 1. Defining transition plans

The required content and format of transition plans should be better specified to ensure the comparability of the information reported by the companies. The requirements should state sectoral targets, differentiate the types of exposures and leverage from the legislative tools to monitor the implementation of the plans.

To ensure the credibility of transition plans, loopholes and weaknesses observed in the current legislative tools, including the EU Green Bond Standards, the Taxonomy and the climate benchmarks, should be fixed.

### 2. Clarifying emerging concepts

The concepts tied to positive and adverse impacts outlined by the Sustainable Finance Disclosure Regulation (SFDR) should be clarified using quantitative thresholds and exclusions and complemented with a notion of transition finance. These should be consistent with the concepts referred to in the Taxonomy Regulation and the forthcoming Corporate Sustainability Due Diligence Directive, addressing the impact of investments on the real economy. Furthermore, the classification of products should undergo revision to prevent its misleading assimilation to a label, unless they adhere to minimum sustainability criteria.

### 3. Recognising the specific risk of fossil fuel financing

Prudential capital requirements for banks and insurers should be enhanced to account for the climate-related financial risks of fossil fuel-related financing and investments. For banks, this should include the introduction of a macroprudential tool in the form of a capital surcharge for fossil fuel exposures at risk of stranding, i.e. exposures exceeding a defined loan-to-value threshold.

### 4. Developing the social factor

A classification system for considering the social dimension in the Taxonomy should be developed to support a just transition.

### 5. Clarifying the role of supervisors

The role of supervisors should be clearly established, and they should be provided with an adequate mandate and tools to carry out their duties. In particular, the role of the ECB and ESAs should be clarified for the monitoring of transition plans given the interconnection between the prudential regulation, the CSDDD and the CSRD. Concerning the latter, the extent of the assurance reviews should be clarified and cover the assessment of the credibility of such plans.

## Introduction

**Amid vast and growing recognition, the threat that climate change and environmental degradation pose to our economic and financial systems is becoming increasingly tangible.** With each passing season, we find ourselves confronted with exceptional weather conditions and extreme events that result in major economic losses. To address this defining challenge of our times, the European Commission acknowledged the pivotal role that the financial sector plays. As a bridge linking financial activities and the real economy, it can support the transition towards sustainability, the limitation of global warming and the mitigation of its economic consequences. Despite sectoral sustainability actions taken over the past few years, massive investment in harmful activities and heterogeneous sustainability ambitions are still observed.

Without dismissing the importance of public funding, regulatory intervention also plays a key role in fostering the development of sustainable projects, mobilising private capital to meet sustainability goals and the commitments outlined in the Paris Agreement, preventing market fragmentation and dispelling the risk of greenwashing. In that context, in 2018, the European Commission adopted an Action Plan designed to meet three overarching objectives: first, the redirection of capital flows towards sustainable investment to achieve a sustainable and inclusive growth; second, the management of financial consequences stemming from climate change, resource depletion, environmental degradation and social issues; third, the establishment of transparency and long-termism in financial and economic activity.

**Since 2018, financial regulation has significantly evolved, and a series of legislative acts and concepts have emerged,** paving the way for finance to become a significant catalyst of a sustainable world. Those evolutions are most welcome. However, although several legislative acts are still to enter into force, a prevailing sentiment echoes that the initial objectives of the sustainable finance agenda, and the impact on the real economy will not be achieved with the current rules. Despite the regulatory response at European and global levels and the Renewed Strategy for Financing the Transition presented by the Commission in July 2021, a lot remains to be done.

**On the one hand, despite the three overarching goals enshrined in the 2018 sustainable finance roadmap, the first regulatory developments have mostly focused on fostering transparency.** This choice likely stemmed from the power of improved transparency to reorient capital flows, the need to define key concepts and metrics for developing credible targets and an optimistic estimation of the potential of consumer and investor fervour for sustainability to change corporate behaviours and drive investments towards a more sustainable economy. On the other hand, the lack of clarity of certain concepts contributed to misleading sustainability claims and confusion for many investors. Finally, a tug of war between short-term gains and a long-term vision has led to distortions in financial markets and skewed valuations of environmentally harmful investments, here exacerbated by the prevailing geopolitical concerns.

**Ahead of the EU 2024 elections, the time has come for legislators to draw conclusions and define their priorities for the next mandate.** Hence, this report focuses on the missing pieces of the EU sustainable finance legislation and provides proposals to remediate inconsistencies among the existing and emerging concepts and the regulatory requirements. The recommendations cover not only the design of solutions for investors and financial institutions that wish to provide sustainable financing, have a positive impact through their investments and manage long-term climate-related risk, but also propose tools to make finance contribute to the transition of the real economy. Transparency is indeed important, but it is no substitute for real action to change corporate behaviour, improve corporate accountability and develop the resilience of our economic and financial systems against increasingly materialising sustainability risks.

Notwithstanding the role that the EU has played in pioneering sustainability concepts, we approach this assessment in a global context. Numerous other jurisdictions are actively developing their own sustainability frameworks, and the interoperability of regulatory standards at a global scale will be a decisive success factor. The EU not only has a role to play in supporting the transition of its own economy, but it is also a global actor channelling capital flows beyond Europe, including to developing countries. Today, it faces a difficulty reconciling the pursuit of its work towards high-quality sustainability standards and fostering interoperability of its legal framework with international developments to prevent market fragmentation. In this context, it is essential to also clarify the role that international standard setters can play in fostering alignment.

**Moreover, social inequalities are arising from climate change and the environmental transition.** Financial institutions are adopting a more granular consideration of sustainability risks, and the most vulnerable communities will face the most severe consequences in many ways. Housing with a lower energy performance will see its price negatively affected, which will result in higher interest rates for mortgage loans, given the loss of value of the underlying mortgage. Buildings in areas at a higher risk of flooding will face growing challenges in obtaining affordable insurance policies. Households will be forced to renovate their houses to improve their energy efficiency, install flood protection etc. Yet in many cases, the housing market has driven lower income groups to areas at a higher risk of flooding<sup>1</sup> and into more energy-intensive buildings<sup>2</sup>. Climate transition must come with social justice, which necessitates balancing the actions taken to prevent and address climate change and social concerns. Achieving a just transition should, however, not become an excuse for slowing down the transition. In fact, the rise in inequalities resulting from inaction will, in the medium to long term, surpass the social cost of an orderly transition. Social concerns must be rather seen as a reason to accelerate the environmental transition.

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1 European Environment Agency, *Urban adaptation in Europe: how cities and towns respond to climate change*, 2020, p. 145.

2 Directorate General for internal policies, *Energy efficiency for low income households*, November 2016, pp. 1-76.



**The debate around the future of the sustainable finance strategy is particularly important in a context where the sustainable finance agenda is facing criticism from all sides.**

First, the identified inconsistencies and unachieved objectives of the regulatory framework jeopardise the credibility of sustainable financing and investments and may affect the interest from investors. Second, the business sector is vigorously lobbying against any additional reporting and regulatory requirement on the grounds of the costs associated with the sustainable finance agenda. Third, the European Union stands as a precursor on sustainability laws, which leads to internal allegations of hampering competitiveness and external opposition because of the implications it holds for non-EU companies operating within the EU. Finally, the prevailing geopolitical landscape and concerns over sovereignty have somewhat shifted priorities, setting a pause in discontinuing certain environmentally harmful economic activities. For example, the percentage of electricity fed in German power grids in the third quarter of 2022 coming from coal-fired power plants significantly increased compared with one year before<sup>3</sup>. Therefore, it is important to reflect on what still has to be done, but also what has to be done better.

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3 Reuters, [Energy crisis fuels coal comeback in Germany](#), December 2022.

## Retrospective on the rise of the EU sustainable finance legislation

Before investigating the necessary legislative improvements, the mapping below shows the development of the initial plan that is expected to be achieved by the end of this mandate. A more detailed retrospective is available in Annex A of this report.

**Table 1: Mapping of the sustainable finance legislative developments with the 2018 EU Action Plan.**

 Finalised
  Ongoing - on track
  Delayed

EU Action Plan		2019	2020	2021	2022	2023
<b>1. Establishing a clear and detailed EU Taxonomy</b>						
Environmental Taxonomy			L1 adopted	L2 adopted (climate)	L2 amended (compl. DA)	L2 amended (6 objectives)
Social Taxonomy					On hold	
<b>2. Creating an EU Green Bond Standard and labels for green financial products</b>						
EUGBSR						L1 adopted
EU Ecolabel					On hold	
<b>3. Fostering investment in sustainable projects</b>						
Cohesion Policy Regulations				2021-2027 programme adopted		
Social Climate Fund						Text adopted
<b>4. Incorporating sustainability in financial advice</b>						
MiFID				L2 adopted (DD and DR)	L3 published	
IDD				L2 adopted	Guidance published	
<b>5. Developing sustainability benchmarks</b>						
Benchmark Regulation		L1 amended	L2 adopted			
<b>6. Better integrating sustainability in ratings and market research</b>						
CRA regulation		L3 amended				
ESG ratings regulation						EC proposal released
<b>7. Clarifying asset managers' and institutional investors' duties regarding sustainability</b>						
SFDR		L1 adopted			L2 adopted	L2 amended
PRIIPS (Retail investment strategy)*						EC proposal released
AIFMD				L2 adopted		
UCITS				L2 adopted		
<b>8. Introducing a 'green supporting factor' in the EU prudential rules for banks and insurance companies</b>						
CRR/CRD				EC proposal released		Final agreement
Solvency II				EC proposal released		Political agreement
<b>9. Strengthening sustainability disclosure and accounting rule-making</b>						
CSRD					L1 adopted	L2 adopted (sector-agn.)
Listing act*					EC proposal released	
ESAP*				EC proposal released		Text adopted
<b>10. Fostering sustainable corporate governance and attenuating short-termism in capital markets</b>						
CSDDD					EC proposal released	Political agreement

\*Part of Capital Market Union 2020 Action Plan

## I. The challenges for the creation of a coherent regulatory framework

### a. Confronting a growing political resistance with sustainability rules

The legislative developments on sustainable finance have encountered growing criticism from diverse stakeholders. Detractors contend that the regulatory load has become counterproductive, that the pace of legislative changes is too high and that policymakers should primarily address climate concerns. A pledge from Ursula von der Leyen, the President of the European Commission, to reduce the reporting requirements by 25% also exacerbated the fears that ambitions on the development of sustainable finance will be lowered<sup>4</sup>.

Although climate change, environmental degradation and social disruptions are increasingly recognised as threats to our economic and financial systems, there is a persistent belief that the most severe impacts of climate change will arrive in the long term and, thus, are not material in the shorter term. As coined by Finance Watch<sup>5</sup>, nothing could be further from the truth. We are already witnessing the increasingly occurring and devastating impacts of climate change and environmental degradation. Back in 2018, the United Nations Secretary-General António Guterres warned that *“the world risks crossing the point of no return on climate change, with disastrous consequences for people across the planet and the natural systems that sustain them”*. The IPCC report published in August 2021<sup>6</sup> also concluded that, without immediate, rapid and large-scale reductions in greenhouse gas emissions, limiting warming to close to 1.5°C or even 2°C will be beyond reach.

Still, business executives and certain political representatives tend to perceive that climate change and other sustainability-related risks will only materialise in the future and have failed to acknowledge the impact that their activities and business decisions may have on climate change and environmental degradation at the systemic level. As a result, the same people openly claim taking consideration of sustainability concerns while advocating for a slowdown of the efforts.

Through this first challenge, we delve into the very heart of the issue: the prioritisation of short-term performance at the expense of longer-term interests, here under the erroneous assumption that companies still have ample time to adapt, regardless of the growing cost of delayed actions. As a result, the reconciliation between the inherent short-termism in the corporate governance system, the operation of financial markets

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4 [Speech by President von der Leyen](#), March 2023.

5 Finance Watch, [Climate impacts loom large on the horizon for the insurance industry](#), December 2022.

6 IPCC, [Summary for Policy Makers of sixth assessment report](#), August 2021.

and the need for investments that will foster companies' competitiveness in the longer term becomes particularly crucial.

## b. Keeping an adequate application timing

The adoption of an effective sustainable finance framework has large implications across companies' operations and their stakeholders. Disrupting traditional financial models by introducing a multidimensional perspective that integrates environmental and social considerations implies adapting financial institutions at the level of their products and services, investments, financing, support functions, governance and value chain. To support this fundamental change, the regulatory framework could not be overhauled in a single instance but the creation of several new pieces of legislation and the adaptation of a number of existing interconnected laws is required, as represented in Annex B. This has resulted in the incremental and parallel development of different legislative files, each of them being subject to a separate adoption process. Unfortunately, the progressive application and delays in reaching political compromise on certain files led to implementation inconsistencies and inadequate practices that undermined the credibility of sustainable finance and generated an avoidable complexity of implementation.

### **Legislative timing constraints: A practical example on sustainability preferences, product disclosure requirements and investee company disclosures**

***Since 2 August 2022**, investment firms have been required, under MiFID II, to consider the sustainability-related preferences of their clients as part of a product suitability test when providing investment advice and portfolio management services. Clients may express such preferences by asking for their investments/portfolio to have a minimum percentage of Taxonomy alignment, a minimum percentage of sustainable investment or to consider certain adverse sustainability impacts.*

*However, financial market participants (FMPs)<sup>7</sup> have only been required to publish their sustainability criteria based on a specific format **since 1 January 2023**. As a result, even when clients' preferences were collected, investment firms initially faced the challenge of capturing the necessary product-level information to extend the existing suitability test to such preferences. This constraint was particularly acute for collecting the necessary product information for third-party products, given the dependence on other asset managers for sharing such information. →*

<sup>7</sup> The notion of Financial Market Participant includes, among others, fund managers, investment firms and credit institutions providing portfolio management services, insurance undertakings distributing insurance-based investment products and institutions for occupational retirement provision.



Furthermore, investee companies are only progressively required to publish their Taxonomy alignment, with the first companies reporting this information for financial year 2022 (**published during the second quarter of 2023**). Therefore, until a full application of the Taxonomy is reached, FMPs themselves will lack part of the necessary information to determine the actual Taxonomy alignment of their financial products.

Finally, the Taxonomy disclosures apply to companies falling under the scope of the non-financial reporting directive (NFRD), which has been amended by the corporate sustainability reporting directive. The CSRD introduces a progressive extension of the NFRD scope, resulting in an increasing number of companies disclosing their percentage of Taxonomy alignment until the CSRD becomes fully applicable.

**Table 2: Overview on the progressive application of the CSRD.**

Note: The overview below will not be impacted by the possible introduction of new thresholds under Directive 2013/34/EC in the context of the reporting relief package<sup>8</sup>.

	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
<b>EU companies</b>							
Companies subject to NFRD							
Other large non-NFRD undertakings							
Listed SMEs ( <i>based on opt-in</i> )							
Listed SMEs ( <i>mandatory</i> )							
<b>Non-EU companies</b>							
EU-listed companies subject to NFRD							
EU-listed large undertakings							
EU-listed SMEs ( <i>based on opt-in</i> )							
EU-listed SMEs ( <i>mandatory</i> )							
Turnover > 150M EUR & EU subsidiary that is listed or a large undertaking							
Turnover > 150M EUR & EU branch > 40M net turnover							

● Application of NFRD      ● Application of CSRD

<sup>8</sup> European Commission, [Delegated Directive](#) amending Directive 2013/34/EU of the European Parliament and of the Council as regards the adjustments of the size criteria for micro, small, medium-sized and large undertakings or groups, October 2023.

This timing discrepancy does not just lead to frustration, but it also impacts the quality of sustainability-related statements and investment advice. For example, it may have long-lasting impacts on how sustainability preferences of investors are considered. ESMA guidelines<sup>9</sup> indicate that investors have the possibility to adapt their sustainability preferences in case the investment firm would not have a suitable offering, which has likely happened in the meantime in response to the missing product-level sustainability information. As a result, investment firms may have built a database of clients with adjusted low preferences that do not reflect the actual client preferences. These lowered preferences may be kept on record and used for subsequent investment product offering for a long period because financial institutions tend to align the review of sustainability preferences with the review of MiFID profiles. The latter are often reviewed every 5 to 8 years for the more conservative profiles since no strict timing has been defined at the EU level.

### **c. Preventing inconsistencies across regulations**

While organising a progressive and parallel development of sustainable finance legislative acts, consistency between legislative files must be ensured. The ordinary legislative process is a complex journey, making it difficult to maintain the consistency between legislative texts:

1. Discrepancies in the notions used under the different texts may appear due to a lack of coordination during the development of legislative texts. For example, we could point differences in the calculations of GHG emission intensity between SFDR and the Benchmark Regulation, as further detailed in this report.
2. Provisions on a specific text may be voted on by co-legislators with no possibility to guarantee their consistency with the developments on other related files. For example, under the Retail Investment Strategy, the Commission proposed an amendment of the key information document content specified in PRIIPS to ensure that key sustainability information is included. However, at this stage, there is no possibility to anticipate possible evolutions of the sustainability concepts in the context of SFDR to ensure consistency between the SFDR product templates, the client's sustainability preferences and the key information document.
3. Political strategies may lead to watering down certain texts at the expense of the global consistency of the legislative framework. Making the CSRD indicators that are necessary for financial market participants to prepare their SFDR principal adverse impact statement subject to materiality assessment is a particularly relevant example.

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<sup>9</sup> ESMA, *Final report* - Guidelines on certain aspects of the MiFID II suitability requirements, September 2022.

When developing sustainable finance regulations, the involvement of different stakeholders, political debates and intense lobbying have heavily interfered with the development of interconnected and consistent rules.

On the other hand, the development of expertise on sustainable finance amongst co-legislators is a dynamic process, and maturity has grown over the past few years. Although early legislative rules had the value of raising awareness and setting the grounds for the next elements of the sustainable finance agenda, they have already become obsolete and need to be revisited.

#### **d. Answering global concerns with European rules**

The EU has positioned itself as a pioneer with its sustainable finance agenda, and it has set strong ambitions in 2018 for moving towards a sustainable economy. However, while sustainability is a global concern, not all countries have followed the trend with the same pace and priorities. In the end, with its limited geographical reach of application, even the most ambitious EU regulation faces significant limitations to contribute to the global transition, which raises the importance of international cooperation.

We can regret that regulatory requirements are not more interoperable, driving the transition at EU level but not necessarily bringing capital flows where it is also necessary at global scale (e.g. in developing countries). However, through its report analysing the common ground between the EU Taxonomy and the China's Green Bond Endorsed Project Catalogue, more commonly named the 'Chinese Taxonomy', the work performed by the International Platform on Sustainable Finance has proven that identifying similarities between taxonomies is a complex exercise. The lack of comparability between the different taxonomies undermines the attractiveness of foreign investments for asset managers that would seek maximising the percentage of Taxonomy alignment of their financial products or their own economic activities. Nevertheless, the recent alignment between ISSB and EFRAG for developing sustainability reporting standards has demonstrated the appetite for improving the regulatory interoperability, despite limitations accentuated by political debates and geographical specificities.

Finally, regulatory discrepancies bring about discussions on short-term competitiveness and the cost of the EU sustainable finance agenda compared with other countries with lower ambitions, regardless of the potential benefits that it would generate for EU companies to be better positioned in the long term.

#### **e. Targeting compliance vs. adapting behaviour**

Supporters of an ambitious transition of the financial sector share concerns that financial actors may only focus on a compliance-based strategy and invest in the quality of their reporting more than in actually changing behaviours and implementing a principle-based strategy. This could result in an unlevel playing field between smaller impact-driven institutions, which are not always in a position to implement robust reporting, and traditional large financial institutions focusing on reporting rather than achieving impacts.

Such a narrow approach may have consequences on the actual transition of the financial sector and its effective role in supporting the real economy transition. By focusing solely on specific indicators to be reported, financial institutions run the risk of:

1. Addressing measurable concerns and neglecting complex and qualitative considerations;
2. Financing mostly large EU companies that are able to provide high-quality reporting instead of supporting smaller companies and/or channelling capital flows to developing countries to support their sustainable development;
3. Reporting strong sustainability indicators while indirectly financing other projects with high adverse impacts;
4. Neglecting topics that are less mature from a regulatory perspective (e.g. social and ethical concerns);
5. Focusing on greening their own portfolios/balance sheets on paper without aiming at achieving a transition of the real economy.

However, this challenge can be partly overcome through ambitious governance rules to ensure that corporate behaviours better integrate sustainability concerns.



## II. The limitations of the current legislative framework

Considering (1) the identified challenges of the sustainable finance agenda, (2) the sustainable investing practices and claims that are currently observed, (3) the continuous funding of environmentally harmful projects and (4) the concerns that the sustainable finance regulatory framework would drive capital flows away from the activities that need financing to transition in favour of activities that are already sustainable<sup>10</sup>, it seems fair to say that the work is ongoing and that the EU has not yet achieved the three initial overarching goals of its sustainable finance agenda.

Although growing the existing sustainable economy is an important element of sustainable finance, transitioning the unsustainable part of the economy is also crucial. Further actions should therefore be pursued to set up the necessary means to achieve a sustainable transition, set the right transition targets and ensure their adequate implementation. This means specifying and completing, where necessary, the existing regulatory requirements, as well as bringing those in coherence with one another.

**First, the transparency requirements are not sufficiently specified, which have led to heterogeneous interpretation and statements that could be misinterpreted by most investors.** In particular, SFDR disclosures offer high flexibility, making it very challenging for investors to understand the actual sustainability level of their investments and the impact that those may have on the transition of the real economy.

**Second, as shareholders' decisions remain primarily driven by short-term interest in financial returns,** the level of ambitions of companies decreases when it comes to adopting sustainable corporate and investment practices. Today, management and investors' decisions are mostly driven by the next quarterly profit figures as they have no incentive to reduce short-term profits in favour of the company's performance for the next decades. This also leads to inadequate valuation of investments that are deemed to lose their value (be stranded) in the longer term as the economy transitions towards sustainability. Hence, it is worth assessing the options that would lengthen the time horizon for the corporate decision-making. So far, the measures to foster long-termism from a sustainability perspective have mostly been limited to weak unspecific provisions on engagement and variable remuneration such as requirements to link a proportion of variable remuneration to the achievement of a company's sustainability objectives, which are still on the table for discussion.

Prudential rulebooks also set requirements to promote the development of robust governance structures. Duty of care for directors, risk management and internal audit committees, deferred variable remuneration are measures that aim at guaranteeing

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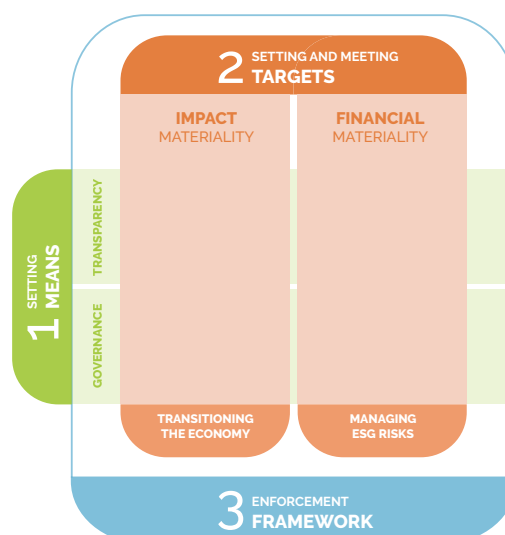
<sup>10</sup> European Commission, *Revised Strategy for Financing the Transition to a Sustainable Economy*, July 2021.

sound decision-making and fostering the safety of financial institutions. However, the impact of those measures remains limited, and they fail to address issues that will materialise beyond the next five years.

**Third, there is very little detail on what transition plans should look like.** The concept of transition plan was introduced in the CSRD as a means for companies to design their pathways for aligning with the objectives of the Paris Agreement. The current finalisation of several pieces of legislation is expected to set the ambition for companies and financial institutions to develop such transition plans. However, additional policy actions should foster the setting of adequate science-based targets. It will be crucial to clarify the key steps and expectations to design robust, achievable and effective transition plans and to implement and disclose them.

**Finally, significant work still needs to be done to ensure that rules are appropriately enforced.** Beyond increasing the awareness of supervisors' staff, several policy actions should be considered to clarify the role of different supervisors and the sanctions to which companies are exposed.

**Figure 1: The different dimensions of the sustainable finance framework.**



As per Figure 1, the necessary actions can be summarised in three streams:

- i. Providing the means for financial institutions to support the transition by finalising the already well-advanced transparency framework, taking into account identified gaps and developing an adequate governance framework to foster long-term decision-making;
- ii. Setting clear mandatory targets, both for managing sustainability risks and for developing a credible plan for the companies' activities to be aligned with the target of limiting global warming as much as possible<sup>11</sup>;

<sup>11</sup> As coined by Finance Watch in its 2023 report '*Finance in a hot house world*', it is unfortunately unrealistic to reach the 1.5°C target of the Paris Agreement (p.28).

- iii. Taking the right enforcement measures to ensure that legislative requirements are actually implemented. In particular, consistency between the national competent authorities of the different EU member states on the interpretation of the rules, the internal expertise and the supervisory actions will be of the essence to ensure regulatory compliance and prevent market fragmentation.

### ***The G as a means, the E and the S as targets:***

*As explained in Finance Watch's policy brief 'Regulating ESG Ratings to Strengthen Sustainable Investors', between the three dimensions of ESG, governance is of a different nature than the environmental and social factors. Governance is indeed a means and a prerequisite to support the transition and reach the targets determined for environmental and social objectives.*

## **a. Setting the means for the transition**

### **i. Fostering transparency**

Transparency is a prerequisite for enabling sustainable investments. There is no possibility for investors to achieve their sustainable investing goals if they do not have the necessary information to do so. This implies obtaining fair, clear and not misleading information from multiple sources, including publicly available information, statements published by corporates, data collected or estimated by data providers, opinions and scorings from ESG rating providers, sustainable investment strategies and commitments from asset managers and financial advisors.

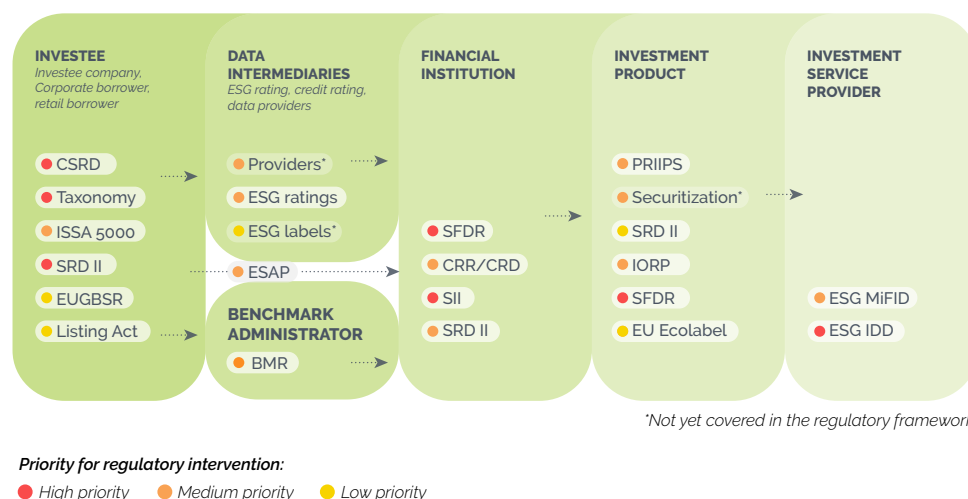
Transparency requires considering all sustainability information that may in fact be produced, collected and processed at the level of the different intermediaries during the investment and financing process. Therefore, transparency should be ensured through entity-level and product-level rules to avoid misleadingly portrayed products, companies or financial service providers. Sustainability-related information may be used, produced, transformed and published by different stakeholders in a way that inappropriate practices of one stakeholder can contaminate the entire chain of information. To avoid this situation, it is essential to look into each step of the information flow, from the moment it is reported by investee companies until the moment it is used for providing client financial services. This will ultimately ensure that the information always remains accurate, fair, clear and not misleading for the end users and that greenwashing and social washing do not distort risk assessments.

### A lack of clarity on transparency requirements is not only a source of greenwashing:

Beyond the risk of greenwashing, the lack of clarity on transparency requirements has also led certain companies to fear that their sustainability claims would be involuntarily misleading. This generated the rise of a new concept: the risk of greenhushing. Companies may refrain from adopting an ambitious position on sustainability matters and communicating on their sustainability strategy to prevent any reputational or legal risk. On the one hand, companies with ambitious sustainability claims are exposed to regulatory compliance risk and possible sanctions. On the other hand, they are also subject to more scrutiny from civil society organisations. Although supervision and civil society scrutiny are beneficial to prevent and identify misleading statements, an insufficiently specified transparency framework may also lead companies not to present themselves as leaders, avoid communicating on genuine sustainable initiatives and possibly limit their actual ambitions.

For each stage of the information flow, the EU sustainable finance agenda has already introduced transparency requirements through dedicated regulatory texts, but improvements are needed. In the table below, these improvements are prioritised depending on how essential they are for the sustainable finance agenda objectives.

**Figure 2: Overview of the legislative requirements on transparency of sustainability-related information and the required improvements.**





### **Investees: Insufficient scope and quality in non-financial reporting**

*The scope of reported information according to the CSRD and the Taxonomy have not yet met the initial ambitions and data quality will need to be carefully monitored.*

The quality of disclosures by investees<sup>12</sup> plays a critical role as it will serve as an important source of information for financial institutions as well as other intermediaries. Misleading ESG claims or inaccurate indicators may impact the rest of sustainability information flow (e.g. ESG ratings or the percentage of sustainable investment of financial products). Therefore, it is key that investees disclose high-quality information including, when applicable, in their non-financial reports, prospectuses or sustainability-related marketing communications. Without these data, it will not be possible to compare companies and implement an effective sustainable investment strategy.

**Yet the publication of sector-specific sustainability reporting standards, which were planned to start being released by late 2023, is expected to be postponed until 2026<sup>13</sup>.** The Commission instead requested EFRAG to prioritise guidance to support companies in implementing the first set of standards. The development of sector-specific standards should not be deprioritised as they will tackle concerns that have not been reflected in the sector-agnostic standards to prevent over-complexity for non-relevant sectors.

**Moreover, the environmental Taxonomy should still be completed with additional essential classification systems: the social Taxonomy and the Taxonomy of environmentally harmful activities (the so-called ‘red’ Taxonomy):**

- The importance of setting up a social Taxonomy is twofold. On the one hand, it will promote the development of socially responsible business models and the integration of this concept in investment and financing strategies. For example, investments could aim at reducing negative impacts for workers (e.g. workplace adaptation to make workplaces more inclusive) or enhancing the inherent positive impacts of an economic activity (e.g. improving access to healthcare or housing for certain groups of people). On the other hand, a climate transition can only take place where the most affected communities are supported for a just transition and, to this end, the social Taxonomy may complement actions taken by governments to manage the social consequences of climate change and the environmental transition.

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<sup>12</sup> The notion of investee is considered in its wide meaning for this report, covering issuers of securities, issuers of bonds, corporate borrowers or retail borrowers. An investee may itself qualify as a financial institution.

<sup>13</sup> European Commission, *Proposal for a decision of the European Parliament and of the Council amending Directive 2013/34/EU as regards the time limits for the adoption of sustainability reporting standards for certain sectors and for certain third-country undertakings*, October 2023.

Despite the initial work performed by the Platform on Sustainable Finance (PSF),<sup>14</sup> the development of a social Taxonomy is on hold as of 2023 and it should be made a priority for the mandate of the next Commission. Reaching an agreement will, however, require policymakers to decide on the many possible technical dimensions that a social Taxonomy can take, whether in terms of objectives, criteria or hard references in a world where social issues are not, by construction, science-based and are, therefore, apprehended differently in different jurisdictions.

- The ‘red’ Taxonomy would allow properly indicating whether the economic activities that are not aligned with the current Taxonomy are harmful or not. Today, a company could disclose a high percentage of taxonomy-aligned activities while being particularly harmful for the part of activities that are not aligned. This is typically the case for companies from the fossil fuel sector that, on the one hand, increase their production of green energy and, on the other hand, continue developing particularly harmful fossil fuel activities. Moreover, such extended Taxonomy could serve as a transitioning tool by identifying which activities should primarily transition or, alternatively, be brought to an end.

#### Finance Watch’s policy recommendations

- Reinforce the Taxonomy Regulation by further detailing the social dimension and introducing the notion of environmentally harmful economic activities.

#### **Data intermediaries: Inadequate use of the information and absence of gold standards**

*The unregulated use of ESG ratings and the absence of high-ambition ESG labels for financial products may lead to misleading sustainability claims.*

**The structure and the transparency of ESG ratings currently do not allow investors to understand the objectives and the underlying methodology of the rating, and there is no safeguard to ensure that those ratings are free of conflicts of interests.** The Commission proposal for regulating ESG rating providers, released on 13 June 2023, is a good basis for improving the governance and transparency of ESG ratings, and integrates many recommendations made in Finance Watch’s policy brief ‘Regulating ESG ratings to strengthen sustainable investors’<sup>15</sup>. However, the following elements will need to be considered to ensure that the new regulation reaches its ambitions:

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<sup>14</sup> Platform on Sustainable Finance, *Final Report on Social Taxonomy*, February 2022.

<sup>15</sup> Finance Watch, *Regulating ESG ratings to strengthen sustainable investors*, May 2023.

1. Forbid the provision of an ESG rating in the form of a single metric and require ESG ratings to be disaggregated into standalone E, S and G assessments;
2. Forbid the provision of ESG ratings and the provision of consulting or audit activities to the rated entity, within the same group;
3. Better align the proposal with Article 6a of the Credit Rating Agency Regulation by setting quantitative ownership/control thresholds to prevent conflicts of interests;
4. Design a template to facilitate the comparison of the information disclosed by the ESG rating providers.

Currently, the proposal does not specify minimum methodological requirements for ESG ratings. At the current stage of the ESG rating market developments, there might indeed not be sufficient common understanding of whether minimum methodology requirements are desirable and what criteria should be used. On the one hand, methodology requirements may limit the global legislative interoperability. On the other hand, we expect that transparency requirements and improvements of data availability will incentivise ESG rating providers to further enhance their offering, such as by developing more ratings addressing the double materiality principle and leveraging from the recent regulatory tools.

Interfering with the methodology could be considered at a later stage, considering the evolution of the ESG rating market, but it may also appear that regulating the use of ESG ratings would be more relevant. Issuers and financial institutions may indeed reuse ESG ratings and even distribute them with misleading statements. Today, many issuers are disclosing their own ESG ratings without specifying if they rely on a single or double materiality principle, nor whether they are based on an absolute or a relative assessment. If retail investors and consumers are likely to access claims based on ESG ratings, minimum transparency or quality standards should be specified in the appropriate legislation (e.g. for the disclosure of ESG ratings in the CSRD sustainability reports or for the use of ESG ratings to determine the percentage of sustainable investment according to SFDR).

### **Example of a misleading use of ESG ratings:**

*MSCI could provide a 'AAA' ESG rating for company A. For instance, MSCI describes its assessment of a company performance as aiming 'to measure a company's resilience to long-term, financially relevant ESG risks'<sup>16</sup>. Company A may indeed prove a strong resilience to ESG risks but only be ranked as 'average' from an impact materiality perspective. As per the Commission proposal, MSCI would be required to publicly disclose information on the ratings' objective, clearly marking whether the rating is assessing risks, impacts or some other dimensions. In turn, company A could reuse this rating in its marketing communication and include it in its sustainability reporting. Company A could even omit making explicit that the rating focuses on financial materiality and pretend that it is more sustainable than it actually is.*

*In such disclosures, which are most likely to be used by retail investors and consumers to access the information, the use of ESG ratings should not be misleading and should take into account the level of understanding of most users of the information. Therefore, although we support not interfering with the methodology of ESG providers, there is a need to regulate the permitted use of ESG ratings in other legislative texts (e.g. the CSRD and SFDR).*

**The Commission also started an initiative for creating a voluntary scheme –the EU ecolabel for retail financial products—to identify financial products meeting criteria of environmental excellence, but the initiative is currently on hold<sup>17</sup>.** The EU Ecolabel could complement industry labels (e.g. ISR in France, Towards Sustainability in Belgium, Luxflag in Luxembourg)<sup>18</sup> by requiring an ambitious Taxonomy alignment so that the number of labelled products increases only as companies are actually transitioning. However, reaching an agreement on the minimum criteria to be applied seems challenging, and the coexistence of such a label with industry labels and the disclosures of Taxonomy alignment could lead to further confusion. The Commission's consultation on SFDR<sup>19</sup> introduces the possibility to define minimum criteria for four categories of financial products, which could partly substitute for the initial development of an EU Ecolabel and even reinforce it with a category of product focusing on transition finance as the distinction between a sustainable investment and transition finance becomes crucial to ensure that capital flows play a catalyst role in transitioning the real economy.

<sup>16</sup> MSCI, *ESG Ratings Methodology*, June 2023.

<sup>17</sup> *EU Ecolabel for Retail Financial Products project*.

<sup>18</sup> Some of the industry labels also involve public institutions in the development of the minimum criteria to be respected.

<sup>19</sup> European Commission, *Targeted consultation document: Implementation of the Sustainable Finance Disclosure Regulation*, September 2023.



### Finance Watch's policy recommendations

- Integrate minimum requirements for the use of ESG ratings in specific legislative texts such as the CSRD and SFDR and reconsider, after a period of application of the ESG ratings regulation focusing on transparency and governance, the need for regulatory intervention on the content of ESG ratings and their methodologies.

### **Benchmark administrators: Inadequate methodology of EU Climate Benchmarks and misleading use and absence of minimum criteria for all climate and sustainability benchmarks**

*ESG and Climate benchmarks are used by asset managers to claim passive investing to be an impact investing strategy.*

Although EU Paris-aligned and EU climate transition benchmarks (the 'EU PAB' and the 'EU CTB') have introduced more transparency for climate benchmarks, important conceptual limitations and methodological weaknesses strongly reduce their added value to meet sustainable finance ambitions.

**GHG intensity vs. absolute emissions.** The EU PAB and EU CTB pose a key problem with the use of metric to assess GHG emissions. Indeed, the methodology prescribed in the Delegated Act<sup>20</sup> uses a GHG intensity metric to define GHG reduction targets.

Two issues arise from this situation:

First, the formula of the GHG intensity metric is inconsistent between the Benchmark Regulation, which uses the enterprise value, and SFDR, which uses the revenue of investee companies:

$$\text{GHG intensity}_{\text{Benchmark Regulation}} = \left( \frac{\text{absolute GHG emissions}}{\text{enterprise value including cash (EUR millions)}} \right)$$

$$\text{GHG intensity}_{\text{SFDR}} = \left( \frac{\text{absolute GHG emissions}}{\text{investee company's revenue (EUR millions)}} \right)$$

Second, GHG intensity, whether based on the enterprise value or the revenue, is not the right metric to measure decarbonisation results. This is a fundamental issue that has been repeatedly raised by Finance Watch, including in its report 'The Problem Lies

20 Commission Delegated Regulation (EU) 2020/1818 of 17 July 2020 supplementing Regulation (EU) 2016/1011 of the European Parliament and of the Council as regards minimum standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks.

in the Net'<sup>21</sup>. The intensity approach, whether promoted or de facto accepted by SBTi and many industry alliances, does not reflect the fact that global warming is fed by actual emissions, not intensity, giving a false impression of progress towards a carbon neutral economy and making targets easier to reach. GHG emission reduction targets should only be expressed in absolute amounts.

**Passive investing vs. active investing.** Benchmarks can be used in two ways: they can help compare portfolios to determine whether a portfolio outperforms the benchmark for a specific market, or they can allow financial institutions to replicate the performance of a benchmark through passive investing. However, the latter is problematic for investors aiming at making a difference, given the very limited engagement of passive investors with their investee companies. Active investment should be promoted over passive investing. Passive investing results in relying on large market indices and on an autonomous transition of the company while renouncing the decision-making over what does and does not get financed and blindly trusting benchmark administrators and the economic modelling they use. Today, the concerns are exacerbated by the confirmation from the Commission that products following EU PAB or EU CTB should classify as 'funds with sustainable investment objective' under Article 9 of the Sustainable Finance Disclosure Regulation<sup>22</sup>.

**Divestment vs. engagement.** As a result of passive investing, financial products following climate benchmarks are encouraged to divest from high-emitting companies instead of engaging for their transition. Targeting the decarbonisation of a portfolio without targeting the decarbonisation of the real economy is not an effective way to achieve meaningful impact.

**Synthetic products vs. physical holding.** The replication of a benchmark can take various forms, including structured products or exchange-traded funds (ETFs), which may not ultimately result in a physical investment in the underlying investee company. Synthetic products should not be allowed to make sustainability claims and pretend they are following a sustainability index.

**EU Climate Benchmarks vs. other climate benchmarks.** Finally, benchmark administrators are allowed to create climate and sustainability benchmarks with low levels of sustainability characteristics. The EU PAB and the EU CTB that have been recently introduced follow specific rules, but such benchmarks are only voluntary. This means that benchmark administrators are not obliged to create an EU Climate Benchmark (EU PAB/EU CTB) and are allowed to create other sustainability benchmarks. In its intermediary report<sup>23</sup>, ESMA pointed out the greenwashing risks of impact claims related to

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21 Finance Watch, *The problem lies in the net*, June 2022.

22 European Commission, *Answers to questions on the interpretation of Regulation (EU) 2019/2088, submitted by the European Supervisory Authorities on 9 September 2022*, April 2023.

23 ESMA, *Progress report on greenwashing*, May 2023.

climate and ESG benchmarks other than legally recognised EU Climate Benchmarks. ESMA proposed the following measures:

1. Increasing the transparency of methodologies applied by the benchmark administrators to ensure that climate benchmarks that are not EU PAB or EU CTB clearly disclose their sustainability characteristics;
2. Enhancing the coherence between the Benchmark Regulation with other more recent sustainable finance legislative acts;
3. Introducing naming conventions to avoid misleading names of ESG benchmarks that would not be subject to the EU PAB or EU CTB criteria.

### Finance Watch's policy recommendations

- Reinforce the methodology for benchmarks to be qualified as EU PAB and EU CTB, as described in the Benchmark Regulation delegated acts, and prohibit the use of the GHG intensity metric to assess the decarbonisation of the investments.
- Resolve the confusion on the limited potential of climate and sustainability benchmarks for contributing to the transition of the real economy through a review of SFDR and the inclusion of additional conditions on engagement and physical holding of investments for ETFs to be considered as pursuing a sustainable objective.
- Foster transparency and define minimum standards for climate and sustainability benchmarks that are not qualifying as EU PAB and EU CTB.

### **Financial institutions: Lack of transparency and readability of the entity-level disclosures**

*The current entity-level disclosure requirements do not provide sufficient details on the content and the format of disclosures, and leave too much flexibility in defining key concepts, which compromises the comparability between financial institutions, their client advice and the products they are managing.*

Financial institutions are themselves part of the transparency chain at two levels. First, financial institutions may themselves be issuers/investees and, therefore, subject to the general CSRD/Taxonomy disclosures referred to in the first step of the information flow (Figure 2). Second, financial institutions are collecting, processing and producing sustainability-related data on their investments to comply with financial sector-specific disclosure requirements, including the following:

- Financial market participants (e.g. portfolio managers and managers of other financial products) and financial advisors (FA) are required to publish information

on the consideration of ESG risks in their investment decision-making process, their client advice and their remuneration policy.

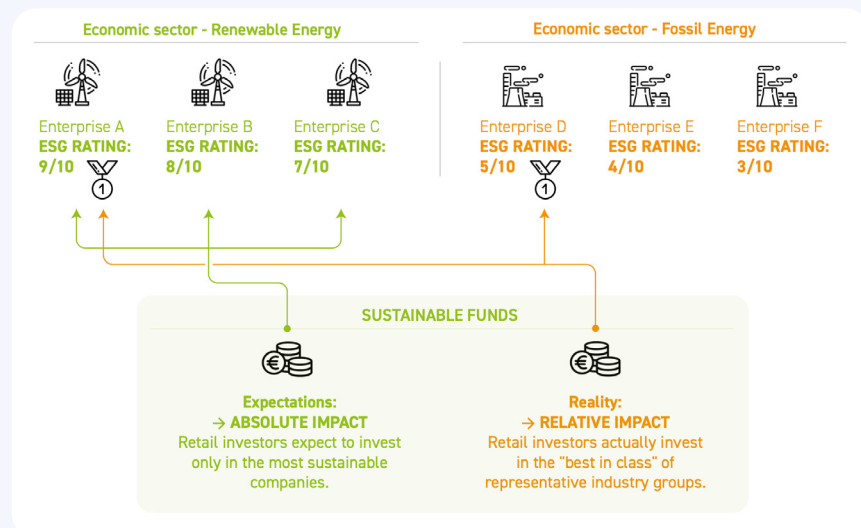
- Financial market participants (FMP) are also required to disclose their assumptions for assessing the key parameters of sustainable investments, their engagement with investee companies and how adverse impacts on sustainability factors are taken into account.
- Credit institutions are required by CRD Pillar III to make additional disclosure requirements on ESG risks.
- Insurance undertakings will also be subject to additional disclosure requirements based on the ongoing review of Solvency II.

However, only a few details are provided for FMPs and FA to prepare their disclosures. Essential concepts for assessing the positive and the negative impact of investments and entities' activities are also not clearly defined, making the comparison between those financial institutions often impossible. Indeed, entity-level disclosures suffer important transparency limitations, particularly regarding the key concepts introduced for financial market participants to disclose how they integrate sustainability characteristics in their investment and engagement strategies.

**Sustainable investment definition.** In particular, SFDR allows very different methodologies for the definition of sustainable investments, which ultimately reveals a great disparity between products with the same SFDR classification and disclosing the same level of sustainable investment. As a result, SFDR has opened the door to all kinds of greenwashing practices.

### A zoom in on some inconsistencies of the notion of sustainable investment

Today, FMPs have adopted very different approaches to determine which investment can be considered as sustainable, and they may combine different investment strategies to do so (e.g. best-in-class, exclusions, controversy screening, theme selection). In their approach, certain asset managers decided to exclude all companies active in the fossil fuel sector, considering the harm that the sector is causing on the environment. However, other asset managers decided to stick to a best-in-class strategy and allow fossil fuel companies to be potentially considered as sustainable, depending on their transition actions and targets. This could result in considering a fossil fuel company as a sustainable investment, while another company in renewable energy would not be considered as such because it would underperform its peers. This concern is represented in the figure below with reference to Finance Watch's policy brief 'Regulating ESG Ratings to Strengthen Sustainable Investors':



While a best-in-class strategy can seem consistent with the aim of fostering transition within polluting sectors, it remains questionable in a context where the overall ambitions of the fossil fuel sector to reduce their production are still very low and even best-in-class players continue being heavily involved in new exploration and extraction projects, often to the detriment of local communities. →

*Companies that are already green and those that are transitioning with ambitious targets should not be aggregated, and the concept of transition investment should be separately defined. The aggregation of both concepts leads to major confusion and inconsistency that has been repeatedly raised in the press, impacting the credibility of the sustainable finance agenda.*

*Finally, some FMPs are relying on ESG ratings in order to develop their own methodology to define the notion of sustainable investment, usually by identifying investee companies with a higher rating. However, most of the ESG ratings are currently not taking into account double materiality and are usually not expressed in absolute value but as a comparison between companies of the same sector. A blind use of ESG ratings focusing on a best-in-class strategy and on the financial materiality perspective would strongly impact the quality of the methodology to define the notion of sustainable investment.*

To meaningfully define a sustainable investment, several questions need to be answered: Should the concept of sustainable investment identify companies that are already green? Should it identify companies that are not necessarily green but that serve as enablers for other companies to transition? Should it identify companies that may be unsustainable but are taking transitioning actions, in which case we need to define which actions are sufficient to minimise negative impacts? For the latter question, the line between the notion of contributing to sustainability objectives and considering negative impacts is thin and should be better defined. For example, a company decreasing its carbon emissions will decrease its negative impact but may also be considered as having a positive impact. Hence, it is critical that the notion of sustainable investment is defined with minimum criteria to prevent such a confusion.

**Adverse impact consideration.** Similarly, there is an ambiguity for determining to what extent a financial product considers an adverse impact. Financial market participants are indeed required to describe their policies to identify and prioritise principal adverse impacts on sustainability factors<sup>24</sup>, but there are no minimum requirements defining when adverse impacts can be recognised as being considered. Therefore, some asset managers can be much stricter on criteria and values than others. This is particularly problematic as the consideration of adverse impacts is part of the sustainability preferences that clients can express when seeking investment advice. The notion of consideration of principal adverse impacts would also overlap with the potential definition of transition finance (see below for further details on this). Therefore, the legislators would need to determine when an asset manager can claim that it considers adverse

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<sup>24</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, Article 4.



impacts related to GHG emissions for its investments and when this consideration is sufficiently ambitious to define its investment strategy as transition finance.

These clarifications are of the utmost importance in a context where the concepts of sustainable investment and adverse impacts—as defined by SFDR—are also used under the ESG MiFID and ESG IDD delegated acts<sup>25, 26</sup> to allow clients under advisory or discretionary portfolio management services to define their sustainability-related preferences. The loose definition of these concepts only contributes to the growing mistrust of private investors in green/sustainable finance.

### Finance Watch's policy recommendations

- Clarify the concept of sustainable investment in SFDR through the inclusion of minimum criteria and the distinction between the notion of sustainable investment and the notion of transition finance.
- Define the concept of considering principal adverse impact with minimum criteria and prevent its overlap with the concept of sustainable investment. Alternatively, consider principal adverse impacts indicators solely as a list of mandatory indicators to be reported, both at entity and product level, in which case the notion of sustainability-related preferences in MiFID and IDD will need to be adapted.

### **Investment products: The confusion about the sustainability characteristics of instruments, the limited coverage of financial instruments and their transition potential**

*The current disclosure framework for financial products leads to misleading interpretation for retail investors and does not capture all financial instruments and their limitations to drive capital flows towards a sustainable transition of the real economy.*

Beyond the introduction of the notion of sustainable investment and principal adverse impact, SFDR has drawn the initial frame of transparency on sustainability matters at financial product level. However, the observed practices, the rising maturity on the topic and the evolution of the legislative framework require urgent structural adaptation. As per the current text, the Commission considers that SFDR should not provide minimum criteria for a product to be marketed as 'sustainable' but that FMPs should

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25 Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.

26 Commission Delegated Regulation (EU) 2021/1257 of 21 April 2021 amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products.

be transparent about the characteristics of the products. However, this transparency approach has proved to have serious limitations.

**SFDR product categories.** SFDR introduced a classification of financial products based on whether a product promotes sustainability characteristics (so-called Article 8 products) or pursues sustainability objectives (so-called Article 9 products), regardless of the level of commitment and the product impact. This means that an Article 8 product—a product that promotes ESG characteristics—can be classified as such, even with very low sustainability commitments, to the extent that the FMPs disclose those commitments based on specific metrics in a pre-contractual template and actual values in a periodic template. Yet, many actors publicly laud their high ratio of Article 8/9 products, although this says very little on their actual sustainability level. The assimilation of SFDR categories to a form of sustainability label poses a real problem of transparency and evident greenwashing.

The proposition from ESMA for fund naming rules<sup>27</sup> will not solve the problem because it proposes setting thresholds for funds to be named ‘sustainable’ based on the SFDR concept of sustainable investment that itself needs to be revised, as explained above. In fact, if implemented, the proposal may have the opposite effect by pushing more progressive investors to lower the conditions for investments to be considered as sustainable to meet the proposed thresholds.

To answer the concern, two options are possible:

- Removing SFDR categories while maintaining transparency requirements for all sustainable products, in which case product labelling will need to be regulated separately. However, it will be important to consider the impact that eliminating categories could have on the education and awareness of private investors.
- Accepting the use of SFDR as a labelling tool, in which case strict criteria will need to be imposed for different product categories. This is the option proposed by the Commission in its consultation<sup>28</sup> as it considers developing a more precise EU-level product categorisation system based on well-defined criteria. Product categories, to the extent that the selected criteria are sufficiently robust, would be useful as they have the potential of differentiating the different purposes of sustainable investing and, among others, end the confusion between green products, products considering ESG risks and transitioning products. This option therefore seems more favourable. Yet the split of the categories should be done in a different way than according to Articles 6, 8 and 9 of SFDR to better map with the possible sustainable investing purposes.

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27 ESMA, *Consultation paper on guidelines on funds’ names using ESG or sustainability-related terms*, November 2022.

28 European Commission, *Targeted consultation document: Implementation of the Sustainable Finance Disclosure Regulation*, September 2023.

**Concepts of financial products vs. financial instruments.** Another challenge to be addressed in the SFDR revision is its interconnection with various regulations. As mentioned previously, SFDR is used in ESG MiFID delegated act<sup>29</sup> and ESG IDD delegated act<sup>30</sup> to determine clients' sustainability preferences. However, while SFDR refers to the concept of financial products, MiFID II refers to financial instruments. The concept of financial instrument is broader than the concept of financial product as it includes, among other things, derivatives, structured products, as well as stocks and bonds. This creates a regulatory gap that needs to be bridged to avoid inadequate practices.

Investment firms are notably left with a lack of clarity to determine the percentage of sustainable investment for bonds (whether green or not), equity or structured products. Also, the SFDR concept of 'considering principal adverse impact' cannot be directly transposed to a single direct investment (e.g. in company shares or corporate bonds). When considering adverse impacts, asset managers may define internal criteria applying at the level of the portfolio as a whole such as based on averaged value or based on a proportion of the portfolio that should respect specific thresholds. Such an approach cannot be replicated when providing ad-hoc advice. Therefore, this generates issues for investment firms to determine whether a single financial instrument is aligned with the client's sustainability preferences.

**Transition potential of financial instruments.** Disclosures on the contribution of investments to the transition of the real economy also remain limited. As proposed by ESMA in its report on greenwashing, SFDR changes should *"be considered in order to introduce clearer disclosures about SFDR FMPs' firm-wide and fund-specific engagement, proxy voting and general stewardship activities. These disclosures could further complement the information from existing entity-level SRD II disclosures"*<sup>31</sup>. Furthermore, the power for financial products and instruments to actually drive capital flows to the companies in the real economy needs to be better considered, and a clear distinction should be made between synthetic products and products that ultimately result in a physical investment in the underlying investee company.

In its SFDR consultation, the Commission proposed the introduction of four product categories, including *"products with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets they invest in, e.g. investments in economic activities becoming taxonomy-aligned or in transitional economic activities"*

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29 Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.

30 Commission Delegated Regulation (EU) 2021/1257 of 21 April 2021 amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products.

31 Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

*that are taxonomy-aligned, investments in companies, economic activities or portfolios with credible targets and/or plans to decarbonise, improve workers' rights, reduce environmental impacts". Although we support the creation of such a category to end the confusion between green and transition finance in SFDR concepts, the criteria would need to be completed with minimum engagement activities to ensure that the decarbonisation targets are not only set at portfolio level and that shareholders' levers to meet investees' targets are used.*

**Consistency with other investment regulations.** While amending SFDR, it would finally be important to ensure that interoperability with other legislative texts is maintained. In particular, the information on sustainability-related matters in the Key Information Document (KID), which may be introduced through adaptation to the PRIIPS regulation proposed in the Retail Investment Strategy package<sup>32</sup>, should remain consistent with the SFDR disclosure requirements as well as any adaptations that would be done in IDD and MiFID relating to the consideration of sustainability preferences.

#### Finance Watch's policy recommendations

- Design a new SFDR classification providing the distinction between products committing to invest in sustainable activities and products committing to support the transition of companies towards sustainable activities. SFDR should specify minimum criteria for each category of products.
- Redefine a key set of metrics, including on transition finance, that should be consistent between the SFDR product templates, the PRIIPS Key Information Document and clients' sustainability preferences. Such metrics should be used for a wider range of financial instruments and should be easily understood by less-versed investors.

#### **Investment service providers: The limitations of adaptive and alternative preferences**

*The flexibility for the consideration of client sustainability preferences impairs the performance of a transparent suitability test of those preferences.*

Given the lack of sustainability-related data at the time of application of the MiFID delegated acts (both on companies' Taxonomy alignment and at the level of product disclosures), ESMA provided flexible implementation guidelines. In particular, it offers the possibility for investment firms to consider sustainability preference as alternative preferences. This means that a client who would express preferences on a minimum percentage of Taxonomy alignment, a minimum percentage of sustainable investments

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32 European Commission, [Retail investment strategy package](#), May 2023.

and the consideration of principal adverse impacts, will see his preferences being considered as alternatives. Therefore, clients are restricted in the extent to which they can define a high level of sustainability preferences, which ultimately disincentivises asset managers to propose a highly sustainable offering. Whether the client is informed in the questionnaire of this critical detail will also not change the result: beyond the absence of possibility to set combined sustainability preferences, there is an important risk of nudging the client answers and a high probability that the client misunderstands that he/she should first communicate his/her priority preferences.

Moreover, in their questionnaire, investment firms may use different percentages of 'sustainable investment' and 'Taxonomy alignment' in order to better match their product offering. As per the below table, the highest percentage of sustainable investment in the questionnaire (for investment firm A) could, for example, be set at 70% by one investment firm and at 50% by another investment firm (for investment firm B). The client could therefore misunderstand the actual level of sustainability stated in his own preferences. Such values should therefore be predefined by ESMA, taking into account the average level of sustainability of products available in the market.

**Table 3: Transparency risk due to misalignment of values in sustainability preferences questionnaires.**

	Questionnaire firm A	Questionnaire firm B	
Minimum percentage of taxonomy alignment			
Option 1	7%	5%	Risk of misinterpretation of the level of sustainability expressed by the client
Option 2	5%	3%	
Option 3	3%	1%	
Minimum percentage of sustainable investment			
Option 1	70%	50%	Risk of misinterpretation of the level of sustainability expressed by the client
Option 2	50%	30%	
Option 3	30%	10%	

Finally, most investment firms are also suggesting to their clients to follow the 'standard sustainability criteria' proposed by them. However, there are very large differences between market players regarding where the bar is set to define those 'standard criteria'. In fact, in many cases, the consideration of a single principal adverse impact indicator or any percentage of sustainable investment would suffice for meeting those standard criteria. Therefore, clients may end up simply being proposed the traditional offering of the firm. Such minimum criteria should be enhanced, and investment firms should remain in a position to propose financial products meeting those criteria for each investor profile.

On 20 July 2022, EIOPA released a guidance for the application of the consideration of sustainability preferences according to IDD. However, this guidance is non-binding and EIOPA should also propose clear, transparent and ambitious mandatory guidelines.

### Finance Watch's policy recommendations

- Adapt the definition of sustainability preferences in the ESG MiFID and ESG IDD delegated acts to allow clients to express a combination of preferences that would not be considered as alternatives. This should prevent nudging and give clients the possibility to express a high level of sustainability preferences.
- Develop a mandatory questionnaire template to ensure that the way sustainability preferences are collected is not misleading for clients, including the questions and possible answers. Such template should include a standard list of principal adverse impacts that may be considered, if the notion of consideration of principal adverse impacts remains after the review of SFDR.
- Develop stricter guidelines both for IDD and MiFID that, among others, introduce minimum requirements for the 'standard sustainability criteria' that may be proposed by investment firms.

## ii. Transforming governance

Building on the recommendations of the High-Level Expert Group on Sustainable Finance (HLEG), action 10 of the 2018 Action Plan aimed at fostering sustainable corporate governance and reducing short-termism in capital markets<sup>33</sup>.

To this end, the Commission committed to carrying out analytical and consultative work with relevant stakeholders to assess: (i) the possible need to require corporate boards to develop and disclose a sustainability strategy, including appropriate due diligence throughout the supply chain and measurable sustainability targets; and (ii) the possible need to clarify the rules according to which directors are expected to act in the company's long-term interest.

According to a study on directors' duties and sustainable corporate governance outsourced by the Commission<sup>34</sup>, EU-listed companies have been increasingly focusing on the short-term benefits of shareholders rather than on the long-term interests of the company over the past 30 years. Moreover, based on the data gathered, the report

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33 European Commission, [Action plan on sustainable finance](#), March 2018.

34 EY, [Study on directors' duties and sustainable corporate governance](#), July 2020.

noted an upward trend in shareholder pay-outs, which increased from 20% to 60% of net income while the ratio of investment (capital expenditure) and R&D spending to net income has declined by 45% and 38%, respectively. The study argued that sustainability is too often overlooked by short-term financial motives and that, to some extent, corporate short-termism finds its root causes in regulatory frameworks and market practices.

With the CSDDD, a first set of incentives and obligations for companies to pursue sustainability should apply. The new directive will set an obligation for companies in scope to adopt and put into effect a transition plan to ensure that their business model and strategy is aligned with the objectives of the Paris Agreement. To foster the feasibility of these plans and to create the appropriate incentives to respect commitments, a part of the directors' variable remuneration will have to be linked to the plans.

However, the corporate governance provisions are still limited and remain at risk after severe corporate lobbying against the key requirements. There is currently no certainty that provisions on directors' duties to take into account the consequences of their decisions for sustainability matters when fulfilling their duties to act in the best interest of the company will be included. According to the provisional deal reached, the financial services will only play a very limited role to identify, mitigate and address the adverse impacts of corporate operations on people and the planet. At the same time, while the remuneration requirement can seem to be quite a revolution for certain sectors, financial institutions are already subject to specific rules for their variable remuneration definition (e.g. maximum fixed/variable remuneration ratio, deferred remuneration, claw-back arrangements, governance indicators). Yet, these rules did not have a sufficient impact to prevent short-term behaviours.

Therefore, additional provisions will need to be considered in the coming legislative mandate. In particular, clarifications on the minimum level of sustainability-related expertise required and the indicators to assess the alignment with transition plans, their weight (e.g. the percentage of variable compensation linked to this indicator) and their impact on directors' variable remuneration (e.g. the pace at which remuneration decreases) need to be provided.



### Finance Watch's policy recommendations

- Adjust relevant legislative texts, most notably Article 91 of CRD, the joint guidelines 2021/06 from EBA and ESMA on fit and proper requirements and Article 42 of Solvency II, to require that directors and board members have the necessary expertise and experience on sustainability matters in order to be able to act in the long-term interests of the company.
- Reinforce identified staff variable remuneration requirements in the prudential legislative texts or in the EBA guidelines 2015/22, which should include definition of the expected weight of the achievement of transition plans in the KPIs employees' scorecard and the introduction of mandatory clawback mechanisms for sustainability factors.

## b. Setting and meeting the targets for the transition

While transparency is a prerequisite for an effective transition, we cannot solely rely on sustainability-related disclosures, hoping that companies, financial institutions and investors will do the right thing. Given the looming climate emergency, we need bold, impactful and immediate actions. Disclosure requirements alone will not work unless underpinned by an obligation for companies to set the targets and act on them.

In this context, mandatory transition plans can be a powerful tool for financial institutions to support the real economy transition and manage their own transition-related risks. The ongoing EU legislative initiatives to introduce transition plan requirements in the prudential regulation for banks and insurers and in the Corporate Sustainable Due Diligence Directive are crucial developments; yet the final legislative texts are pending the conclusion of the trilogue negotiations as of the time of writing. The specific details and contents of such transition plans still need to be clarified, notably regarding incorporating financial materiality and impact materiality principles.

### i. Managing the risk

Risk-return considerations play a major role in driving the decisions of the economic agents. Thus, accounting for climate-related risks in financial decisions is a necessary prerequisite to align the behaviours of financial institutions' and other economic agents' with the EU objectives of climate neutrality. This, in turn, is a necessary prerequisite for the financial sector to act as a catalyst rather than an impediment to the sustainable transition. Moreover, supervisors have long recognised that climate change, as well as delayed and disorderly transition, represent major threats for the stability of the financial sector and its ability to provide financing to the real economy.

Yet climate-related risks—both physical and transition risks—remain underpriced. First, short-termism prevalent in financial markets hinders the incorporation of the possibly

longer-term horizon of climate-related risk materialisation into market prices and economic decisions. On the part of physical risk, climate-related events feature a number of characteristics, making precise quantification of the associated risks and impacts impossible. These include the non-linear, irreversible and radically uncertain nature of climate change and presence of tipping points once the global temperatures reach certain thresholds. Hence, the probabilities of future climate-related events cannot be inferred using historical data—a fundamental difference to most of the prevalent approaches and models, on which financial risk management and regulation are largely based. On the part of transition risk, short-termism of the existing regulatory framework is exacerbated by the lack of comprehensive government plans and supporting policies to achieve the stated carbon neutrality objective so that financial actors do not perceive transition risk as materialising and are not incentivised to adequately reflect it in their risk analyses. A clear manifestation of this is the sheer volume of financing and investments provided annually to the fossil fuel industry, despite the huge value loss that the industry must suffer if we are to achieve the Paris Agreement objective of carbon neutrality by 2050: the International Energy Agency (IEA) concluded that there is no room for new fossil fuel exploration if emissions are to reach net zero by 2050 as the demand for fossil fuels must drop sharply—by 90%, 75% and 55% for coal, oil and gas, respectively.

Precautionary forward-looking approach to financial regulation is needed to overcome the challenge of climate change. Under the conditions of the unprecedented and radically uncertain nature of climate change, the current regulatory approach focused on transparency and discretionary risk management measures proves clearly insufficient. Climate-related risks should be systematically internalised by financial actors based on the already available information, in particular insights from climate science, international climate objectives and realistic assessment of the economic cost of climate change. Prudential frameworks, which establish the rules for financial institutions' risk management need to evolve to accommodate relevant time horizons and avoid carbon lock-ins, such as when shorter-term financing of fossil exploration projects enables continued production of fossil fuels and locks in the associated emissions for the many years to come. The necessary prudential rules should combine measures targeted at sound risk management and solvency of individual financial institutions with the measures to mitigate the risk at the systemic level.

In previous publications, Finance Watch has brought forward a number of measures to tackle climate-related financial risks, which correspond to the principles outlined above. In particular, these include:

- **Capital requirements** for all forms of exposures (financing and investments), which are subject to identifiably high climate-related financial risks such as exposures related to exploration and production of fossil fuels. Such requirements can be

implemented at the level of individual exposures (microprudential)<sup>35</sup> or at the sectoral level across all fossil fuel-related exposures of an institution (macroprudential). Finance Watch proposal for the microprudential measures have been recognised by experts and regulators as a top-ranked effective measure to tackle the link between climate change and financial instability<sup>36, 37</sup>. Further, Finance Watch has developed a new concept of a borrower-based macroprudential tool—a loan-to-value threshold that triggers a capital surcharge—applied to fossil fuel assets at risk of stranding<sup>38</sup>. The proposed capital measures follow a precautionary approach and overcome the existing data and methodological challenges to measure climate risks precisely. The measures are also coherent with the risk-based nature of prudential regulation.

- **Prudential transition plans** for financial institutions, subject to supervisory review. Transition plans as risk management tools allow to align the institutions' risk assessment with the time horizons that are defined as relevant for the mitigation of climate-related physical risks, which also determine relevant horizons for transition risk management. The role of transition plans for the microprudential supervision has been recognised by the NGFS in the stocktake exercise, which concluded that *"transition plans could be a useful source of information for microprudential authorities to develop a forward-looking view of whether risks resulting from an institution's transition strategy are commensurate with its risk management framework"*<sup>39</sup>. Requirements on prudential transition plans should be aligned with other EU regulations covering transition plan considerations such as the CSRD and CSDDD, which will allow to avoid regulatory overlaps.

Conducting realistic assessments of the cost-benefit analyses of the regulation is crucial. As pointed out in Carbon Tracker's report 'Loading the Dice against Pensions'<sup>40</sup> and Finance Watch's report 'Finance in a Hot House World', climate scenario analyses play an important role in exploring the possible consequences of climate change for the financial sector. Due to the flaws of the models underlying these exercises, possible impacts of climate change are largely underestimated. This distorts the cost-benefit analysis of policy options and, until now, has been one of the important reasons for inaction on the prudential policy part.

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35 Finance Watch, [Breaking the climate-finance doom loop](#), June 2020; Finance Watch, [Insuring the uninsurable](#), July 2021; Finance Watch, [A silver bullet against green swans](#), November 2021.

36 Climate Safe Lending Network, [Financial Stability in a Planetary Emergency](#), April 2021.

37 The EU supervisory authorities EBA and EIOPA have received mandates to investigate the case for dedicated prudential treatment of climate-related and other sustainability risks. As of the time of the report, the work is ongoing.

38 Finance Watch, [Finance in a hot house world](#), October 2023.

39 NGFS, [Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities](#), May 2023, p. 6.

40 Carbon Tracker, [Loading the Dice against Pensions](#), July 2023.

### Finance Watch's policy recommendations

- Evolve the prudential framework to implement precautionary forward-looking approach to climate-related financial risk and time horizons commensurate with the materialisation of this risk.
- Implement capital requirements for climate-related financial risks to safeguard financial stability; in particular, develop a new borrower-based macroprudential tool to address the risk of fossil fuel-related finance.
- Mandate transition plans for financial institutions, subject to prudential supervision.
- Implement a realistic assessment of the economic consequences of climate change based on climate science and robust economic models.

## ii. Transitioning the real economy

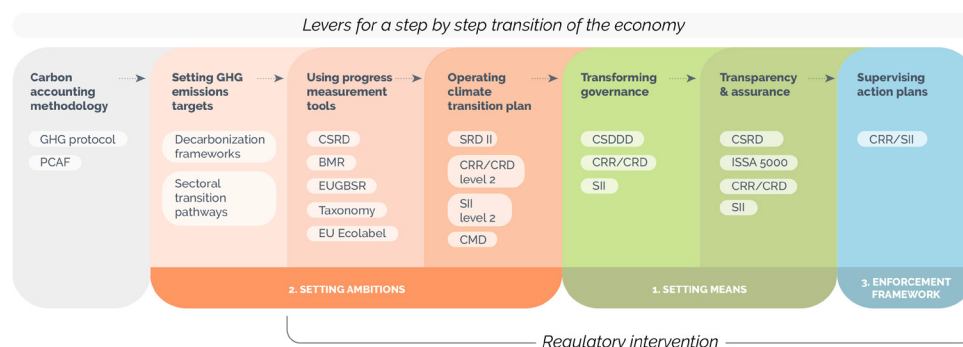
Transition planning and transition plans for financial institutions are now widely recognised as tools to harness the role of the financial sector in the economy in support of transition efforts. In its stocktake report from May 2023, the NGFS stated that *“Transition plans have the potential to become centrepiece in showing the real economy’s pathway to a net-zero future”*<sup>41</sup>.

As the CSDDD is expected to make the adoption of transition plans mandatory, it is now essential to define how those plans should be designed and monitored. In the sustainable finance package of 13 June 2023, the Commission has already drawn a first frame of what transition plans could look like. It provided a series of voluntary recommendations and shared sectoral practices to ensure that companies move from a general strategic ambition to a concrete and realistic action plan.

However, although those recommendations are welcome, additional rules on the content of transition plans are needed to make sure the plans and targets reflect the financial institutions’ contribution and progress to transition the real economy and prevent the risk of greenwashing. Robust transition plans are also essential for investors to assess investee companies’ performance in order to meet their own targets. To do so, it is necessary to identify the standards and legislative frameworks that may interact with each step of designing and implementing transition plans.

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41 NGFS, *Stocktake on Financial Institutions’ Transition Plans and their Relevance to Micro-prudential Authorities*, May 2023, p. 4. The NGFS report distinguishes between the concepts of ‘transition planning’, which it views as a process, and ‘transition plan’, which is the documented result of transition planning. Below, we refer to transition plans more generally, including the procedural elements of designing and implementing a transition strategy.

**Figure 3: The proposed process for transition planning.**

In this report, we focus on the financial sector and the steps where a regulatory intervention is primarily required to establish a robust and coherent framework for transition planning of the financial sector. Therefore, the recommendations will not cover adjustments that may need to be made to the carbon accounting and target-setting frameworks. However, these frameworks will play a critical role as they will offer a segmentation of approaches per type of exposure/activities and per sector.

Indeed, the very first step for companies to design and implement a plan is to assess the existing situation in terms of their sustainability risks and impacts, as required by the CSRD. At this stage, it is crucial to adopt the right methodology to estimate the direct and indirect GHG emissions, which can imply very different approaches. For example, the methodology for calculating GHG emissions linked to equity investment will be different from the methodology for mortgage loans or for sovereign exposures.

The second step is to identify realistic transition targets for meeting the Paris Agreement objectives, taking into account ambition that can actually still be achieved<sup>42</sup>, and taking into account that not all sectors should have the same ambitions. In order to ensure that priorities are well identified and that targets are aligned with the ambitions we should achieve, intermediary and ultimate targets will need to be defined taking the following key considerations into account :

1. The current situation regarding the absolute GHG emissions and environmental impact of each sector, its actual capacity to transition and corresponding investments needed;
2. The existing sectoral pathways and the regulatory landscape that would already drive the transition of sectors (e.g. the impact that the Energy Performance Building Directive on the energy efficiency of existing and new buildings); and
3. The climate scenario taken as a baseline ambition (e.g. a scenario aligned with a 1.5°C trajectory).

<sup>42</sup> Finance Watch, *Finance in a hot house world*, October 2023, p.28.

Based on this, financial institutions will be able to set up action plans with intermediary targets and take the necessary organisational measures to reach the defined medium- to long-term targets. In order to establish such a transition planning framework, an adaptation of several legislative texts will be required. In the absence of common and granular sectoral pathways with sufficient geographic breakdown and common set of underlying scenarios used by all economic actors, the consistency and reliability of transition efforts might be jeopardised.

### **Using progress measurement tools: Enhancing the tools to achieve real economy transition targets**

*Transition tools leave loopholes that may undermine the actual contribution to the transition of the economy.*

In its sustainable finance package from 13 June 2023, the Commission published recommendations on facilitating finance to transition to a sustainable economy. The document referred to a series of regulatory tools that may support financial institutions in defining their targets: the EU Climate Benchmarks, the Taxonomy Regulation, the EU Green Bond Standards and the CSRD. The latter is probably the most evident tool as companies subject to the CSRD will be required to report their transition plan if they have one. The financial undertaking would then be able to leverage on their investee companies' transition plans to design and monitor their own plan.

However, investments are not always made in corporate bonds and equity of companies reporting under the CSRD, and it may not always be easy to assess the GHG emissions related to an underlying exposure or activity and to set reduction targets. Hence, the other intermediary tools proposed by the Commission (the EU Climate Benchmarks, the Taxonomy Regulation, the EU Green Bond Standards) could be used to set more tangible targets that can be more easily monitored. In particular, the Taxonomy alignment will need to play a key role in the target-setting. Although it is no assurance that a business model will be aligned with the objectives of the Paris Agreement by being fully aligned with the Taxonomy, it is a powerful tool for setting intermediate goals, defining non-climate environmental targets as well as overcoming the limitations on data availability for certain exposures (e.g. real estate).

Thus, it is essential to ensure credibility of such tools, including understanding and, when possible, correcting their limitations. As shown in Figure 1, meeting transition targets requires considering interconnections with the other dimensions of the sustainable finance framework (setting the means and enforcing the requirements). Indeed, as mentioned, there is no way to achieve an adequate transition without sufficient transparency and an adequate supervision framework. In fact, the issues discussed in the first chapter regarding transparency directly impact the credibility of transition plans, whether it concerns the transparency of tools used for measuring the achievement of transition targets or governance, risk management and disclosure practices of financial institutions. The recommendations below may therefore reiterate recommendations

previously made, in light of their impact on the implementation of transition plans.

Concerning the tools to measure transition progress, we point out the following most acute limitations and corresponding required policy actions:

1. **Transition plan disclosures are not based on a consistent format and their feasibility may not be assured:** Beyond the transparency issues at the level of issuers previously mentioned, detailed provisions on the format of the transition plans to be disclosed would also help financial institutions to leverage from issuers' non-financial reports. While transition plans need to be disclosed according to the CSRD, there is a risk that the format of transition plans is not comparable between the investee companies, which would impair the quality of financial institutions' plans. Second, attention should be paid to the possible lack of credibility of transition plans. ESMA also noted that the ability for companies to meet their commitments is not sufficiently backed up by plans<sup>43</sup> (e.g. insufficient resources allocated to support the plan, the absence of intermediary milestones and the absence of progress monitoring). While the CSRD has introduced a requirement for non-financial reports to be reviewed based on limited assurance (and ultimately based on reasonable assurance<sup>44</sup>), the role of assurance service providers to assess the quality of the plans is still unclear.
2. **Interoperability of the taxonomies needs to be improved:** Investors struggle to estimate their percentage of Taxonomy alignment when investments are made outside the EU. Indeed, next to the EU Taxonomy, no less than 50 taxonomies have been developed across the globe, with each of them having their own specific contents, objectives and use. Moreover, the development of taxonomies has been increasingly politicised, and important differences between the taxonomies developed can be observed. Despite the challenges flagged in the previous part of this report, the Commission should support the interoperability of the EU Taxonomy with classification systems from other jurisdictions by pursuing the work started by the International Platform on Sustainable Finance (IPSF) and issuing adequate tools to allow appropriate comparison and estimates. This will help foster sustainable investments in other jurisdictions, particularly in developing countries. To improve interoperability, international standard setters should also play an important role by developing recommendations for a common ground between taxonomies.
3. **Criteria of sustainability benchmarks should be revised:** As previously

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43 ESMA, *Progress report on greenwashing*, May 2023.

44 As explained in CSRD recitals, the conclusion of a limited assurance engagement is usually provided in a negative form of expression by stating that no matter has been identified by the practitioner to conclude that the subject matter is materially misstated. The conclusion of a reasonable assurance engagement is usually provided in a positive form of expression and results in providing an opinion on the measurement of the subject matter against previously defined criteria. Therefore, the auditor performs fewer tests in a limited assurance engagement than in a reasonable assurance engagement.



noted, EU Climate Transition Benchmarks and EU Paris-Aligned Benchmarks can be part of a toolkit for designing portfolios that would meet transition targets. However, the underlying methodologies set in the delegated acts should be improved, notably by taking into account sectoral transition pathways and the measure of GHG emissions. In particular, decarbonisation targets should be expressed in absolute values, and the GHG intensity metric should not be used. Finally, as previously mentioned, the use of benchmarks should be better specified to prevent the development of EU PAB/EU CTB products that would not result in a physical holding of the underlying securities, which would need to be tackled in other legislative texts such as SFDR.

4. **Transparency and minimum ambitions for non-regulated green bonds should be fostered:** The EU Green Bond Standard Regulation offers strong standards for EU green bonds with a high percentage of Taxonomy alignment. However, because green bonds are not required to follow those standards, many will question whether creating voluntary standards and labels matches the urgency of the looming climate and environmental crisis. Minimum criteria and transparency requirements should apply so that those bonds can also be used to assess their contribution to the transition targets. However, we should acknowledge that such changes will not be considered in the short term as this would require adapting the level 1 of the EU Green Bond Standards Regulation, which was finalised in October 2023.
5. **Financial product labels should be developed:** The introduction of EU-level labels with minimum criteria, such as based on the four product categories proposed by the Commission in the context of the review of SFDR, would support institutions to set harmonised minimum targets to reach their transition objectives.

### Finance Watch's policy recommendations

- Clarify in the CSRD delegated acts the expected content and format of transition plan disclosures to facilitate the comparability of companies' transition plans and their use by financial undertakings to develop and implement their own plans.
- Strengthen the ISSA 5000 (International Standard on Sustainability Assurance 5000) expectations for assurance service providers to assess the fairness and credibility of transition plans disclosed, as per the CSRD.
- Support the interoperability of the EU Taxonomy with classification systems from other jurisdictions by pursuing the work started by the IPSF and issuing adequate tools to allow appropriate comparison and estimates. Although the development of a global interoperable taxonomy framework could be described as wishful thinking, we encourage EU legislators, European Supervisory Authorities and international standard-setters to pursue their reflection on how to best overcome the barriers of multiple taxonomies.
- Introduce minimum standards for all sustainability benchmarks. Ensure that a robust methodology is defined in EU PAB/CTB benchmarks and that decarbonisation targets are expressed in absolute values not based on the GHG intensity metric.
- Introduce minimum criteria and transparency requirements for all sustainability/green bonds to help assess the contribution of those products to the transition targets achievement.
- Develop EU labels with minimum criteria, both for green financial products and products focusing on transition finance, leveraging from the percentage of Taxonomy alignment of the products.

### **Operating climate transition plans: Developing concrete implementing actions**

*Concrete transition actions are not sufficiently integrated in the current legislative framework.*

The CSDDD currently does not introduce guidelines on how actions should be defined, and the CSRD leaves an important flexibility on how transition plans should be designed, which ultimately could lead to heterogeneous transition plans with various levels of intermediate ambitions. Prudential rules mandate supervisory authorities to provide further details on the content of transition plans, but the alignment of prudential provisions with the CSDDD and the CSRD will need to be specified through binding rules that would set expectations for the relevant types of exposures and activities.

In order to ensure that financial undertakings develop credible transition plans and actually play a role in the transition of the economy, detailed expectations will need to be set on the use of the power of stewardship and other levers of influence that financial institutions have as finance and service providers. Inaction based on the assumption that quick divestment can be implemented at any moment should not be permitted because, at a systemic level, such behaviour will lead to a costly disorderly transition scenario. In its 2022 report 'The Problem Lies in the Net', Finance Watch highlighted two important tools at the disposal of financial institutions:<sup>45</sup> equity owners can influence non-financial companies through shareholder engagement, while lenders, insurers and private investors can influence companies by imposing climate target-related conditions and covenants in financing agreements.

Transition planning by financial institutions should also take into account that large companies will already need to have transition plans and that stewardship should mostly address the credibility of the transition plans and the monitoring that ambitions are actually met. Supporting smaller companies and retail clients in the transition should take into account their financial situations and integrate positive incentives, for example, via a preferential pricing, premium, interest rate.

#### **Finance Watch's policy recommendations**

- Amend the Shareholder Rights Directive (SRD II) to i) require ESG investors to publish their plans to engage with investee companies based on comparable format and vote against the management of investee companies that do not adopt and implement credible transition plans, and ii) give supervisors a mandate to monitor climate-oriented engagement and enforcement powers over ESG investors.
- Broaden the scope of the SRD II to cover other capital providers than shareholders and introduce climate-related covenants for lending activities.

#### **Transforming governance:**

As mentioned in the previous chapters, governance and long-termism will play a key role in contributing to sustainable behaviours. In particular, governance provisions will directly contribute to the monitoring and the achievement of transition targets. In particular, management should be held accountable for the actions taken to reach those targets.

Moreover, raising the expertise of the staff and management to develop and implement transition plans will be key to ensure that commitments are met.

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<sup>45</sup> Finance Watch, *The problem lies in the net*, June 2022.

### Finance Watch's policy recommendations

- Adjust sectoral legislative texts, most notably CRD and Solvency II, to ensure that staff, directors and board members have the necessary expertise and experience on the development and adoption of transition plans.
- Reinforce identified staff variable remuneration requirements on the expected link between transition plans and variable remuneration with the latter linked to reaching preset intermediary transition targets.

### **Transparency and assurance:**

*The CSRD, the CSDDD, CRR and Solvency II currently do not sufficiently specify details for disclosing transition plans and integrating them under the assurance engagements.*

The implementation of transition plans will not only lead to making use of the transparency requirements that apply to non-financial and financial undertakings, but they will also feed transparency at the level of the financial undertakings given that such plans must be disclosed in financial undertakings' sustainability reporting. While we can reiterate the need for more detailed provisions on the format of the transition plans, which applies to all financial institutions, it is worth mentioning that transition plans for financial institutions are expected to contain specificities that need to be taken into account. On the one hand, financial institutions' sustainability reporting will need to be consistent on how exposures (by sector such as real estate, utilities, steel but also by type of exposure such as lending, bonds, equity) and targets are segmented to allow comparability. On the other hand, expressing the transition targets only in terms of GHG emissions is not always sufficient for financial institutions, and other tools, such as the EU Taxonomy, need to be activated. Although transition plans need to be disclosed according to the CSRD, the current delegated act does not eliminate the risk that the format of the transition plans could end up not being comparable between financial institutions.

### Finance Watch's policy recommendations

- Clarify the expected content and format of transition plans specifically for financial institutions, taking into account the use of the progress measurement tools and climate transition actions to facilitate the comparability of their transition plans.

### **Supervising action plans:**

Beyond the assurance of transition plan disclosures, the transition plans will need to be scrutinised by supervisors. As coined by Finance Watch in a 2022 report<sup>46</sup>, “*with the prevalence of the climate change debate and of net-zero targets in the financial world, the need for financial supervisors to step in to ensure that net-zero and climate change-related information is clear, accurate and not misleading is now urgent. (...) In its Strategy for financing the transition to a sustainable economy released on 6 July 2021, the European Commission gave itself the task of “enabling supervisors to address greenwashing”.* This endeavour can only be encouraged, given the urgency of the question.”

As we are now expecting to have more enforceable GHG transition pathways once the CSDDD enters in application—with pecuniary sanctions in case of infringement—supervisors should be given a clear mandate to control the quality and effectiveness of the transition pathways of reporting companies, both from their adoption and implementation.

#### **Finance Watch’s policy recommendations**

Give supervisors the mandate and the power to:

- Control the substance of the GHG reporting of companies claiming to be GHG neutral or pursuing net-zero targets.
- Ensure that financial undertakings demonstrate that they take robust actions for reaching their targets.

### **c. Setting an effective enforcement framework**

*The current enforcement framework does not provide sufficient clarity on the responsibilities and nomination of supervisory authorities and the possible sanctions and does not sufficiently integrate the work of international bodies.*

Beyond the supervision of transition plans, supervisors play an essential role in the effective enforcement of the entire sustainable finance framework by identifying, investigating and sanctioning greenwashing practices. This is essential to ensure the clarity and reliability of sustainability information, an effective contribution of the financial sector to a sustainable transition and adequate management of related risks. In fact, the sustainable finance rules can only be useful if they are adequately applied. It is therefore important to:

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46 Finance Watch, *The problem lies in the net*, June 2022.

1. **Clarify the sanction framework:** The sanctions that financial institutions are facing in case of breaches of certain requirements are not well defined. While the proposal for the CSDDD clearly specifies possible pecuniary sanctions, as well as reputational consequences, sanctions for breaches of SFDR or the Taxonomy remain uncertain. In certain member states, monetary sanction ranges are defined in local law. Luxembourg has, for example, specified in the Law of 25 February 2022 that the Commission de Surveillance du Secteur Financier (CSSF) and the Commissariat aux Assurances could pronounce administrative fines of between EUR 250 and EUR 250,000 in the event of breach with SFDR or the Taxonomy. In other member states, theoretical pecuniary sanctions to which non-compliant companies are exposed (for a breach with SFDR or the Taxonomy) should be interpreted from the sanctions foreseen for unfair commercial practices in the Unfair Commercial Practices Directive (UCPD), though not every breach may be considered as an unfair commercial practice. Bringing legal certainty on the sanction framework in the case of a breach with the Taxonomy and SFDR would facilitate the work of supervisory authorities while preventing an unlevel playing field on the treatment of breaches between jurisdictions.
2. **Clarify the role of each EU supervisor:** Supervisors are currently facing uncertainties regarding their supervisory tasks because of overlaps and interdependencies between sustainable finance legislative acts. As mentioned in the section on transition plans, the role of the ECB, the EBA, ESMA and EIOPA for the supervision of the quality of transition plans and the supervision of other provisions in the CSDDD and the CSRD needs to be specified in order to prevent missing, inefficient or redundant oversights.
3. **Take into consideration the work of international standard setters:** International bodies are increasingly promoting the more robust management of ESG risks and the development of sustainable finance initiatives. Initially, most initiatives were focusing largely on disclosures, which are insufficient on their own when it comes to averting the looming environmental crisis and ensuring financial stability. However, the NGFS has been examining the relevance and extent to which financial institutions' transition plans relate to microprudential authorities' roles and mandates and could be used within their supervisory toolkit and in the overall prudential framework<sup>47</sup>. FSB, BCBS, IAIS and IOSCO are also launching coordinated initiatives to address climate-related financial risks.<sup>48</sup> The EU legislators and supervisors will therefore need to ensure that regulatory developments and supervisory activities are consistent with the work done by international bodies.

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47 NGFS, *Stock-take on transition plans*, May 2023.

48 FSB, *Roadmap for Addressing Financial Risks from Climate Change: 2023 Progress Report*, July 2023.

### Finance Watch's policy recommendations

- Establish the role of supervisors, in particular the role of the ECB and ESAs for monitoring transition plans given the interconnection between prudential laws, the CSDDD and the CSRD, and provide them with an adequate mandate to carry out their duties.
- Stipulate pecuniary sanctions for infringement with transparency provisions as uncertainty remains whether SFDR and Taxonomy breaches would systematically fall in the sanction framework of the Unfair Commercial Practice Directive.



### III. Recommendations for an effective transition

To address the limitations identified across this report, we propose that the Commission adapts a series of legislative texts during the next mandate and brings the following amendments/developments:

#### a. Taxonomy Regulation

Reinforce the Taxonomy Regulation by further detailing the social dimension and introducing the concept of environmentally harmful economic activities, and subsequently develop technical criteria for the latter to identify the concerned economic activities.

#### b. CSRD

Clarify the expected content and format of transition plans to facilitate the comparability of companies' transition plans and their use by financial undertakings to develop and implement their own plans.

Clarify the expected content and format of transition plans specifically for financial institutions, taking into account the use of the progress measurement tools and climate transition actions to facilitate the comparability of their transition plans.

Strengthen the ISSA 5000 expectations for assurance service providers to assess the fairness and credibility of transition plans disclosed as per the CSRD.

Define minimum requirements in the CSRD for the use of ESG ratings in sustainability reporting.

#### c. SFDR

Clarify the concept of sustainable investment in SFDR through the inclusion of minimum criteria and the distinction between the notion of sustainable investment and the notion of transition finance.

Define the concept of considering principal adverse impact with minimum criteria or, alternatively, consider principal adverse impacts indicators solely as a list of mandatory indicators to be reported, both at entity and product level. In the latter case the notion of sustainability-related preferences in MiFID and IDD will need to be subsequently adapted.

Design a new SFDR classification providing the distinction between products committing to invest in sustainable activities and products committing to support the transition of companies towards sustainable activities. SFDR should specify minimum criteria for each category of products.

Redefine a key set of metrics—including on transition finance—that should be consistent between the SFDR product templates, the PRIIPS Key Information Document and the client sustainability preferences. Such metrics should be used for a wider range of financial instruments and should be easily understood by less-versed investors.

Resolve the confusion on the limited potential of climate and sustainability benchmarks for contributing to the transition of the real economy through a review of SFDR and the inclusion of additional conditions on engagement and physical holding of investments for ETFs to be considered as pursuing a sustainable objective.

#### **d. PRIIPS**

Adapt the key information document to ensure consistency between the SFDR product disclosure requirements and sustainability preferences, as defined in the IDD and MiFID delegated acts.

#### **e. Benchmark Regulation**

Reinforce the methodology for benchmarks to be qualified as EU PAB and EU CTB, as described in the Benchmark Regulation delegated acts, and ensure an absolute decarbonisation of investments.

Foster transparency and define minimum standards for climate and sustainability benchmarks that are not qualifying as EU PAB and EU CTB.

#### **f. MiFID/IDD**

Adapt the definition of sustainability preferences in the ESG MiFID and ESG IDD delegated acts to allow clients to express a combination of preferences that would not be considered as alternatives.

Develop a mandatory questionnaire template to ensure that the way sustainability preferences are collected is not misleading for clients, including the questions and possible answers. Such template should include a standard list of principal adverse impacts that may be considered, if the notion of consideration of principal adverse impacts remains after the review of SFDR.

Develop stricter guidelines, both for IDD and MiFID, that, among others, introduce minimum requirements for the ‘standard sustainability criteria’ that may be proposed by investment firms.

#### **g. SRD II**

Amend SRD II to require ESG investors to publish their plans to engage investee companies based on comparable format and to vote against the management of investee companies that do not adopt and implement credible transition plans. Give supervisors a mandate to monitor climate-oriented engagement and enforcement powers over ESG investors.

Broaden the scope of the SRD II to cover other capital providers than shareholders and introduce climate covenant duties for the lending activities.

#### **h. CRR/CRD/Solvency II**

Amend Article 91 of CRD, the joint guidelines 2021/06 from EBA and ESMA on fit and proper requirements and Article 42 of Solvency II to ensure that directors and board members have the necessary expertise and experience on sustainability matters in order to be able to act in the long-term interests of the company and adopt and implement credible transition plans.

Reinforce identified staff variable remuneration requirements in the prudential legislative texts or in the EBA guidelines 2015/22, which should include definition of the required weight of the achievement of transition plans in the KPIs employees' scorecard, the expectations for preset intermediary thresholds and the introduction of mandatory clawback mechanisms for sustainability factors.

Evolve the prudential framework to implement precautionary forward-looking approach to climate-related financial risk and time horizons commensurate with the materialisation of this risk.

Implement capital requirements for climate-related financial risks to safeguard financial stability; in particular, develop a new borrower-based macroprudential tool to address the risk of fossil fuel-related finance.

Implement a realistic assessment of the economic consequences of climate change, based on climate science and robust economic models.

#### **i. Transversal amendments**

Clearly establish the role of supervisors, in particular the role of ECB and ESAs for monitoring transition plans given the interconnection between prudential laws, the CSDDD and the CSRD, and provide them with an adequate mandate to carry out their duties.

Stipulate pecuniary sanctions for infringement with transparency provisions as uncertainty remains whether SFDR and Taxonomy breaches would systematically fall in the sanction framework of the Unfair Commercial Practice Directive.

## Conclusion

The work achieved during this legislative mandate has set a number of necessary foundations for the financial system to foster the transition to a more sustainable economy. The initial focus on transparency was a necessary prerequisite as credible targets could only be set if financial institutions have access to transparent and comparable information.

Yet inconsistencies and gaps in securing the quality, the accuracy and the transparency of the sustainability-related information flow need to be addressed during the next mandate.

This additional work is necessary to respond to the growing scepticism around ESG investing stemming from, among others, the flexibility for defining emerging sustainability concepts. Today, loopholes are leaving well-intentioned financial institutions in legal uncertainty, exposing them to evolving legislative interpretation, and leaving sustainable investors without the clarity they need to truly invest sustainably.

To respond to such concerns, financial and non-financial undertakings will also need to accept that clarity should be achieved by reducing implementation flexibility. Sustainable finance operates within an interconnected framework that extends beyond the boundaries of each financial institution. Therefore, it requires a holistic and harmonised approach, which should replace a fragmented implementation of flexible rules.

That being said, an effective transition will not be achieved through transparency rules alone. The ongoing finalisation of the Corporate Sustainability Due Diligence Directive and the necessary adaptation of prudential rules should pave the way for the next mandate: fostering long-term corporate behaviours, designing credible, effective and transparent transition plans with an active engagement from financial institutions, adapting financial institutions' capital requirements to reflect sustainability risks and ensuring that the progressive implementation of the sustainable finance rules is supervised.

The recommendations in this report essentially aim to point at solutions to make the current legislative landscape more consistent and meet the priorities above while contributing to better working regulations. The road towards making finance contribute to a more sustainable economy has to be an iterative process. The next mandate will determine whether policymakers are ready to make the best use of the tools developed over the past five years to contribute to an effective transition and adopt the rules that are indispensable to link the sustainable finance and the financial stability agendas.

## Annex A - A yearly retrospective on the rise of sustainable finance legislations:

During the past five years, no less than 20 pieces of legislation have emerged or have been amended to integrate sustainability considerations in the financial world, each of them constituting pieces of a puzzle that still need to be assembled before identifying the missing ones.

This retrospective evaluation provides a more comprehensive overview of the milestones of the sustainable finance agenda that have been completed, but also emphasises the legislative files that still need to be finalised before exploring ways of enhancing the effectiveness of the legislative framework, which is done in the main parts of this report.

### 2019: The first transparency requirements for the sustainable finance agenda

The first big milestone of the sustainable finance regulatory agenda, the ***sustainable finance disclosure regulation (SFDR)***, sets disclosure requirements for financial products and entities that qualify as financial advisors or financial market participants. With this text, the Commission intended to:

- Bring more transparency at entity-level on (1) how financial institutions are managing sustainability risks in their investment decision-making process, (2) how financial institutions are considering principal adverse impacts and (3) how financial institutions are integrating sustainability risks in their remuneration policies;
- Bring more transparency at product-level on (1) how financial products integrate sustainability risks, (2) whether financial products promote ESG characteristics or have sustainable investment as objective and (3) how the ESG characteristics or sustainable investment objectives are met.

In particular, SFDR defined a classification of financial products based on their sustainability claims, which then triggered the transparency requirements.

SFDR mainly introduced two key application dates: 10 March 2021 for general disclosures and 1 January 2023 for detailed disclosures based on ESAs' regulatory technical standards. These standards define the details of content and format for the pre-contractual and periodic disclosures for products that at least promote sustainability characteristics and for the entity-level principal adverse impact statement.

The Commission also developed, through amendments to the ***Benchmark Regulation***, climate and ESG benchmarks to put forward standards for the methodology of low-carbon benchmarks in the EU. In particular, the amended text introduced an EU Climate Transition Benchmark and an EU Paris-Aligned Benchmark. In practice, those benchmarks may serve for passive investment strategies or for benchmarking the investment performance for GHG emission-related strategies.

## 2020: The first steps for the Taxonomy

The year 2020 has been marked by the adoption of the Taxonomy Regulation, a key element of the sustainable finance agenda that established a classification system to determine whether economic activities can be considered environmentally sustainable. In a nutshell, the first level of the text sets six environmental objectives (climate change mitigation, climate adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems) and a three-step test for an economic activity to qualify as environmentally sustainable: (1) the economic activity should substantially contribute to one of the 6 objectives, (2) the economic activity should not significantly harm any of the five other objectives, and (3) it should respect minimum social safeguards.

As a second step, a second level of the **Taxonomy Regulation** was foreseen to specify the list of eligible economic activities and quantitative and qualitative criteria to be respected to meet the substantial contribution and do no significant harm principle. This step was itself divided in two subsequent delegated acts: a first delegated act focusing on the two climate objectives and a second delegated act focusing on the four other objectives. Ultimately, companies required to publish a non-financial report will have to report on their alignment with the Taxonomy Regulation. The application of the requirement starts one year earlier for the non-financial undertaking and progressively increases in scope.

**Table 4: Overview of the progressive application of the Taxonomy Regulation.**

	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
<b>Climate objectives</b>								
Non-financial undertaking								
Financial undertaking								
<b>All environmental objectives</b>								
Non-financial undertaking								
Financial undertaking								

● Taxonomy-eligibility   
 ● Taxonomy-alignment   
 ⋮ CSRD progressive application

## **2021: The introduction of sustainability preferences and the Taxonomy first delegated act**

Following the publication of the 2021 sustainable finance package, including the proposal on the CSRD and multiple delegated acts complementing the Taxonomy, MiFID, IDD, AIFMD and UCITS, the co-legislators agreed on new or adapted rules concerning:

- For **IDD and MiFID**:
  - The consideration of clients' sustainability-related preferences by investment firms and investment advisors in the context of the suitability test when providing investment advice (including insurance-based investment products) and portfolio management services
  - The management of conflicts of interest related to sustainability preferences
  - The inclusion of sustainability-related objectives in the product governance obligations
- For **AIFMD and UCITS Directive**:
  - The consideration of sustainability risk and factors by asset managers, both for UCITS and alternative investment funds.
- For the **Taxonomy Regulation**:
  - The list of economic activities eligible to be considered as environmentally sustainable and the qualitative and quantitative criteria to be respected.

In particular, the IDD and MiFID delegated acts introduced the definition of sustainability preferences as being the choice to invest in financial instruments:

- With a minimum proportion of environmentally sustainable investments according to the Taxonomy Regulation
- With a minimum proportion of sustainable investments according to the SFDR
- Considering principal adverse impacts on sustainability factors, whether or not based on the SFDR list of principal adverse impacts.

The year 2021 was also marked by the industry-led initiatives. In this context, a global coalition of financial institutions, the **Glasgow Financial Alliance for Net Zero** (GFANZ) was created to accelerate the decarbonisation of the financial sector and the economy.



### **The DWS case**

*The year 2021 was also marked by important greenwashing accusations against DWS Group for overstating its sustainable investing efforts and misleading investors by marketing its funds as greener than they actually were<sup>49</sup>. Investigations from supervisors started after DWS's head of ESG publicly pointed out misstatements in the 2020 annual report regarding the size of its ESG assets. The scandal led DWS' CEO to step down one year later.*

## **2022: The year of the CSRD**

The Non-Financial Reporting Directive was amended with the adoption of the **Corporate Sustainability Reporting Directive** (CSRD) that provides details on the content and the format of non-financial reports. The CSRD also included adaptations to other legislative pieces, such as to the Audit Directive, by introducing a requirement for the non-financial reports to be assured (first limited assurance, then reasonable assurance).

Second, the Taxonomy **climate delegated acts** were amended to add certain controversial economic activities, such as power generation from gas and nuclear energy to the list of economic activities eligible for Taxonomy alignment.

Finally, the co-legislators agreed on the final **SFDR delegated acts**, one year later than the initial plan because of discussions on technical details of the regulatory technical standards. The delegated acts introduced pre-contractual and periodic reporting templates for Article 8/9 products, content details for website disclosures and a template for the principal adverse impact statement.

## **2023: The setting of targets and the finalisation of open legislative files**

In 2023, several important milestones of the sustainable finance agenda were finalised:

- **The European Green Bond Standard Regulation introduces** voluntary standards for European Green Bonds, including a minimum percentage of alignment with the Taxonomy and specific disclosure.
- The delegated acts on the four **remaining objectives of the Taxonomy Regulation** providing the full list of activities eligible for being considered as environmentally sustainable. On top of this, the climate delegated acts were also completed. It is further expected that the Taxonomy delegated acts will continue evolving over time, notably by setting criteria for considering agricultural activities as environmentally sustainable.

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49 Reuters, [DWS to pay \\$25 mln to end US probe into greenwashing](#), September 2023.

- The long awaited final **CSRD delegated acts** were approved and set the content of the environmental, social and governance information to be included in non-financial reports. The delegated acts are mainly based on the draft standards developed by the EFRAG but include a reduction of certain requirements: (1) an extension of the number of disclosures subject to a materiality assessment, (2) the introduction of voluntary disclosures, including on biodiversity transition plans and certain ‘own-worker’ disclosures and (3) the inclusion of an additional phase-in of reporting requirements for certain indicators, notably for companies with less than 750 employees.

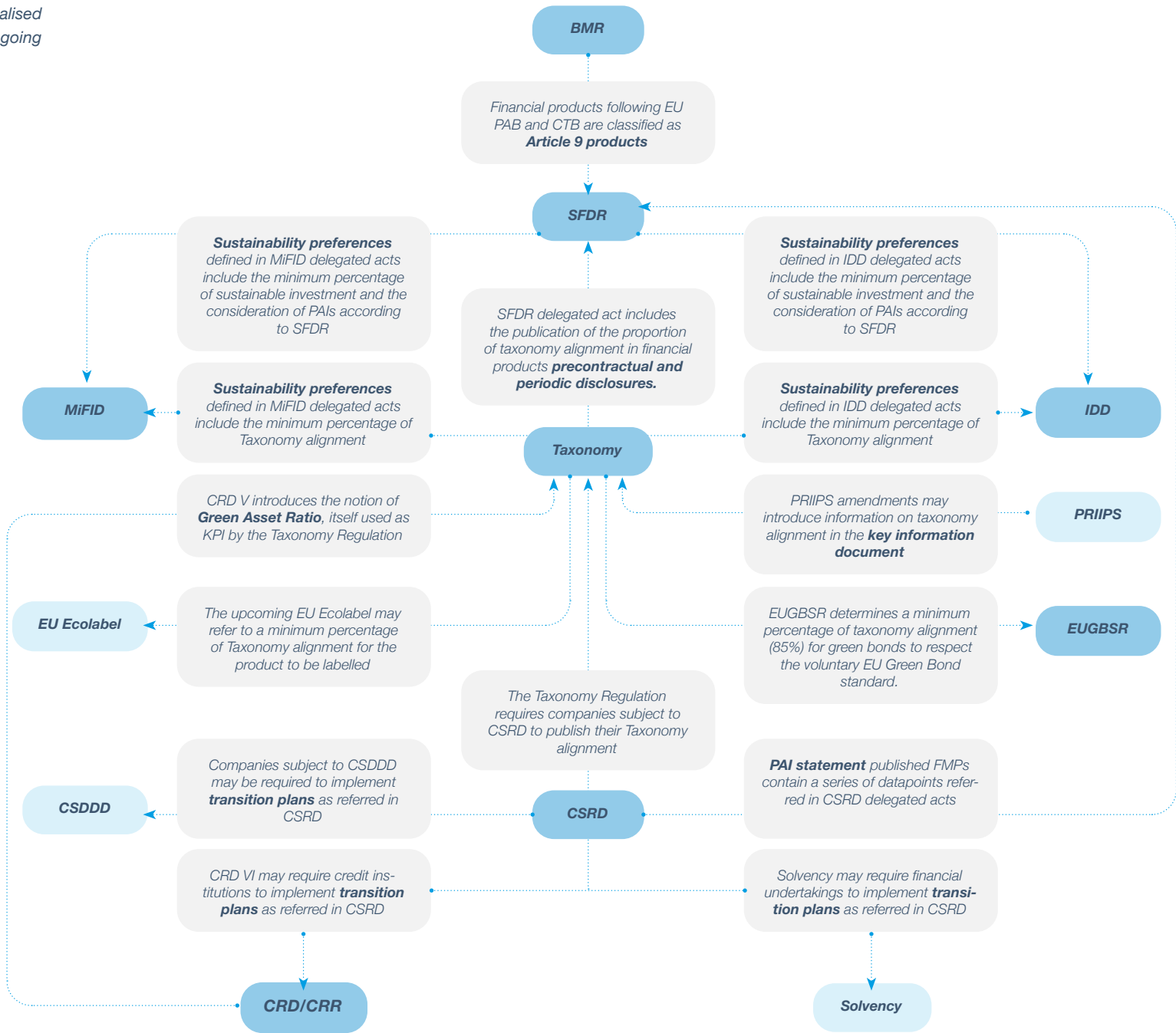
Several legislative texts are expected to be finalised before the EU elections 2024:

- **The Corporate Sustainability Due Diligence Directive:** The draft text introduces value chain due diligence requirements and related directors’ responsibilities, mandatory transition plans and their linkage with directors’ remuneration.
- **The CRR/CRD and Solvency II:** The draft texts introduce prudential requirements for ESG risk management, governance and supervision. In particular, the amendments to the CRR/CRD and Solvency II introduce requirements on climate transition plans, including mandating prudential supervision thereof.
- **The ESG rating provider regulation:** The proposal sets authorisation provisions, governance and transparency requirements for ESG rating providers in order to allow investors to adequately understand and use ESG ratings. In particular, the text is expected to introduce requirement to manage conflicts of interests, as well as to increase transparency on (1) the objectives of the ratings (impact vs. financial materiality), (2) the distinction between E, S and G ratings and (3) the distinction between absolute and relative (e.g. based on best-in-class assessment) ratings.

# Annex B

## Overview of interactions between the pieces of sustainable finance regulation

- Legislative process finalised
- Legislative process ongoing



## Glossary

<b>AIFMD</b>	Alternative Investment Fund Managers Directive
<b>BCBS</b>	Basel Committee on Banking Supervision
<b>BMR</b>	Benchmark Regulation
<b>CRA</b>	Credit Rating Agency
<b>CRD</b>	Capital Requirements Directive
<b>CRR</b>	Capital Requirements Regulation
<b>CSDDD</b>	Corporate Sustainability Due Diligence Directive
<b>CSRD</b>	Corporate Sustainability Reporting Directive
<b>ELTIF</b>	European Long Term Investment Fund Regulation
<b>EU CTB</b>	EU Climate Transition Benchmark
<b>EU PAB</b>	EU Paris-Aligned Benchmark
<b>EUGBSR</b>	European Union Green Bond Standard Regulation
<b>ESAP</b>	European Single Access Point
<b>ESRS</b>	European Sustainability Reporting Standards
<b>FSB</b>	Financial Stability Board
<b>IAIS</b>	International Association of Insurance Supervisors
<b>IDD</b>	Insurance Distribution Directive
<b>IORP</b>	Institutions for Occupational Retirement Provision Directive
<b>IOSCO</b>	International Organization of Securities Commissions
<b>ISSA</b>	International Standard on Sustainability Assurance
<b>MCD</b>	Mortgage Credit Directive
<b>MiFID</b>	Markets in Financial Instruments Directive
<b>NGFS</b>	Network of Central Banks and Supervisors for Greening the Financial System
<b>PAI</b>	Principal Adverse Impact
<b>PRIIPS</b>	Packaged Retail and Insurance-based Investment Products Regulation
<b>SII</b>	Solvency II Directive
<b>SFDR</b>	Sustainable Finance Disclosure Regulation
<b>SRD II</b>	Shareholder Rights Directive II
<b>UCITS</b>	Undertaking for Collective Investment in Transferable Securities



## About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see [www.finance-watch.org](http://www.finance-watch.org)

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