
State of Play - Status of European Legislative and Regulatory Developments on Sustainable Finance

June 2019

Background and Executive Summary

Following the adoption of the 2015 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the European Commission published its "[Action Plan: Financing Sustainable Growth](#)"¹ having three main objectives:

- Reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth;
- Manage financial risks stemming from climate change, environmental degradation and social issues;
- Foster transparency and long-termism in financial and economic activity.

In May 2018, the Commission adopted a [package of measures](#)² implementing several key actions announced in its Action Plan.

The package included proposals aimed at:

- Establishing a unified EU classification system ("**taxonomy**") on what can be considered an environmentally sustainable economic activity;
- Improving **disclosure** requirements on how institutional investors and asset managers integrate environmental, social and governance (ESG) factors in their risk processes;
- Creating a new category of **benchmarks** comprising low-carbon and positive carbon impact benchmarks to provide investors with better information on the carbon footprint of their investments.

The Commission has taken forward all of these proposals. The current state of play as of June 2019 is detailed below, but can be summarised as follows.

Taxonomy:

- The European Parliament adopted its position on the Commission's proposal. The political negotiations are now at the EU Council level.
- It is expected that discussions will continue into the Finnish Presidency, which starts on 1 July 2019.
- In June 2019, the Commission's technical expert group (TEG) on sustainable finance published its [report on Taxonomy](#)³, providing more detail on the taxonomy itself and its practical application. The TEG is requesting public feedback on the report over July-August 2019, which will further be used by the TEG to advise the Commission on the way forward.
- Once the Taxonomy Regulation has been agreed between the EU Council and the European Parliament, the Commission will consult the public on any measures it will propose under this framework.

Disclosure:

- An agreement was approved between the European Parliament and the EU Council in relation to the text of the EU Disclosure Regulation.

¹ https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en

² https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en#implementing

³ https://ec.europa.eu/info/files/190618-sustainable-finance-teg-report-taxonomy_en

- The Regulation applies to financial market participants if they manufacture financial products, or to financial advisers if they provide advice on investments or insurance (refer further below for the definitions of financial market participants and financial advisers).
- Entities in scope of the Regulation will have to provide disclosure in relation to the integration of sustainability risks and adverse sustainability impacts into investment decision process on their websites, in pre-contractual documentation and through periodic reporting.
- European supervisory authorities (ESMA/EIOPA⁴) have been tasked with developing technical standards for the content and presentation of the required disclosure information.

Benchmarks:

- The European Parliament approved the agreement on low-carbon benchmarks as part of the broader Benchmark Regulation.
- This agreement creates two new categories of voluntary low-carbon benchmarks (EU climate transition benchmarks and EU Paris-aligned benchmarks).
- Benchmark administrators will have to demonstrate compliance with a range of criteria as supported by appropriate disclosure to be able to market the indices to investors.
- In June 2019, the technical expert group (TEG) on sustainable finance also published its [interim report on climate benchmarks and benchmarks' ESG disclosures](#)⁵, which was also followed by a call for feedback open until the end of July. Based on the feedback received, the TEG is expected to publish the final version of the report by the end of September. Following the publication, the Commission will develop a delegated act⁶ considering the TEG report and conduct a formal consultation on the delegated act.

After completing the lawyer-linguist process (i.e. process to ensure that EU legislation means the same in all EU languages), the text of the Disclosure and Benchmarks Regulations will be reconfirmed by the new Parliament and will be approved by the Member States in the Council.

In addition to the three legislative proposals, **the Commission intends to amend Delegated Regulation under MiFID II** with requirements on the integration of sustainability risks in the areas of organisational requirements, product governance, operating conditions and risk management. It is unlikely that any amendments to delegated acts will be taken forward before the second half of the year, which means that the amendments will be subject to approval by the new Parliament.

Furthermore, the Commission has been working to improve the availability and quality of corporate reporting on climate-related information, through **amending the Non-Financial Reporting Directive (NFRD) Guidelines**. The guidelines are aimed at promoting better voluntary disclosures, focused on materiality (significance) of matters disclosed, to improve investment and lending decision-making. They should also better align with existing guidelines, such as the industry-led work by the Task Force on Climate-related Financial Disclosures (TCFD) under the Financial Stability Board (FSB), as well as other existing national, EU-based and international frameworks. The [updated guidelines](#)⁷ were published by the Commission in June 2019.

Finally, the Commission's TEG released its final [report on EU Green Bond Standard](#)⁸ to help boost transparency and comparability of the green bond market and to provide guidance to issuers on the steps to follow for a green bond issuance with an ultimate goal of scaling up green finance. The next Commission will have to decide on how to take the final recommendations forward.

⁴ The European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA)

⁵ https://ec.europa.eu/info/files/190618-sustainable-finance-teg-report-climate-benchmarks-and-disclosures_en

⁶ Once an EU law is passed, it can be necessary to update it to reflect developments in a particular sector or to ensure that it is implemented properly. Parliament and Council can authorise the Commission to adopt delegated or implementing acts, respectively, in order to do this. Source: https://ec.europa.eu/info/law/law-making-process/adopting-eu-law/implementing-and-delegated-acts_en

⁷ [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019XC0620\(01\)](https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019XC0620(01))

⁸ https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-green-bond-standard_en.pdf

EU Taxonomy Regulation

In its plenary session in March 2019, the European Parliament adopted a [position⁹](#) regarding the proposal on “*Establishment of a framework to facilitate sustainable investment*” (EU Taxonomy Regulation). In April, Member States resumed discussions on the file at the EU Council level.

The key **highlights from the text** of the Regulation adopted **by the European Parliament** are as follows:

- Regulation will apply to financial market participants, as defined by the EU Disclosure Regulation (refer further below), offering:
 - Financial products marketed as environmentally sustainable within the EU;
 - Environmentally sustainable investments (or similar) within the EU;
 - All other financial products unless:
 - an explanation and reasonable proof are provided that the activities funded by the product do not have a significant sustainability impact OR;
 - there is a declaration in the prospectus that the product does not pursue sustainability objectives and is at an increased risk of supporting activities considered as non-sustainable.

It may also be applied to other entities and products on a voluntary basis.

- According to the adopted text, **all credit institutions**, as defined by the EU Capital Requirements Regulation (CRR), **are in scope**, meaning that the Taxonomy Regulation would apply to any transactions undertaken by a credit institution as defined in CRR (including own portfolios and transactions in a capacity of arranger, underwriter, agent or distributor).
- The definition of **financial products** generally refers to the EU Disclosure Regulation (includes both manufactured and distributed products and is further specified below) and additionally **includes issuances** of all securities that are offered to the public or admitted to trading on a regulated market, subject to certain exemptions – as set out under the EU Prospectus Directive and Regulation.
- There continues to be a strong focus on creating a **taxonomy for environmentally sustainable (“green”) economic activities** - amendments seeking to introduce criteria for economic activities with a significant negative environmental impact (“brown taxonomy”) as well as respective disclosure requirements did not gain sufficient support in the plenary session. However, **expanding the Regulation with the “brown taxonomy” would be subject to a separate impact assessment by the Commission planned to be completed by 31 December 2021.**
- The text also highlights that application of the Regulation should be **proportional** and should consider **companies in transition** to more environmentally sustainable activities (i.e. the criteria should consider whether the economic activity, or companies that conduct this economic activity, are transitioning towards becoming more sustainable).
- Financial market participants offering financial products **should disclose information** that allowed them to conclude whether the products they offer qualify as environmentally sustainable investments. The **Commission will need to adopt delegated acts which specify the information needed** to comply with such disclosure requirements. As part of this process, the Commission will undertake public consultations and policy assessments.
- Adherence to **OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights** were added to the **minimum safeguards** that financial market

⁹ http://www.europarl.europa.eu/doceo/document/TA-8-2019-0325_EN.pdf

participants will have to apply under the Regulation. The Commission will need to come forward with **delegated acts specifying the criteria** for compliance with these requirements, **which are to be adopted by 31 Dec 2020**. The Commission will review the minimum safeguards by 31 December 2021.

Notably, as part of the ongoing negotiations at the EU Council, the **Romanian Presidency's proposals** suggest that only the **credit institutions providing portfolio management services**, as defined by MiFID II Regulation, be scoped in. Additionally, there are a number of open questions with regard to the governance process around the taxonomy (ensuring its flexibility and neutrality, taking into account technological developments and future sustainability objectives). Nevertheless, there is a general consensus at the Council around the need to establish a **transitional framework** (i.e. defining categories of activities contributing to the transition to low carbon economy). Reaching consensus on the scope of possible transitional categories is expected to be **a critical element to achieving a general agreement on the file** by the Council.

With the debates still ongoing, discussions on the taxonomy will **continue into the Finnish Presidency, which starts on July 1st**.

EU Disclosure Regulation and related changes to the MiFID II Delegated Regulation

The EU Disclosure Regulation introduces additional disclosure requirements for asset managers and institutional investors, in scope, in order to enhance transparency for end investors when considering sustainability risks and Environmental, Social and Governance (ESG) factors in the investment decision making process.

In April, an inter-institutional agreement was approved between the European Parliament and the EU Council in relation to the [text¹⁰](#) of the "*Regulation on sustainability-related disclosures in the financial services sector*" (EU Disclosure Regulation). After completing the lawyer-linguist process, the text will be reconfirmed by the new Parliament and will be approved by the Member States in the Council. The publication of the final text in the Official Journal of the EU is expected in October 2019, with the Regulation entering into force at the beginning of November at the earliest (application date – 15 months after entry into force).

In January 2019 the Commission published an updated draft of a Delegated Act amending the MiFID II Regulation with regard to the integration of ESG considerations and preferences into investment advice and portfolio management. Following the publication of the draft text, the Commission stated its intention to wait for the negotiations on the Disclosure Regulation to be finalised before adopting any amendments to the MiFID II Delegated Regulation.

While the negotiations on the Disclosures file have been finalised, the Commission decided not to adopt further measures before the new Parliament is formed. Additionally, in July 2018, ESMA received a mandate from the Commission to provide technical advice to assist the Commission on potential amendments related to the integration of sustainability risks and sustainability factors in the MiFID II Delegated Regulation. The [advice¹¹](#) was published by ESMA in early May 2019, and ESMA will cooperate with the Commission on translating the advice into changes to the Delegated Act. We expect that further work on amending the Delegated Regulation, including the political process around it, will be resumed under the new Commission and Parliament and will likely to happen **after Q3 2019**.

The **key highlights from the EU Disclosure Regulation** are as follows.

The Regulation applies to financial market participants if they manufacture financial products or to financial advisers if they provide advice on investments or insurance, specifically:

¹⁰ http://www.europarl.europa.eu/doceo/document/A-8-2018-0363-AM-002-002_EN.pdf

¹¹ <https://www.esma.europa.eu/press-news/esma-news/esma-submits-technical-advice-sustainable-finance-european-commission>

- Financial market participants defined as insurers offering insurance based investment products (IBIPs), investment firms and **credit institutions providing portfolio management (as defined by MiFID II)**, pension product manufacturers, alternative investment fund managers (AIFMs), Pan-European Personal Pension Product (PEPP) providers, European Venture Capital Fund (EuVECA) and European Social Entrepreneurship Fund (EuSEF) managers, Undertakings for Collective Investment in Transferable Securities Management Companies (UCITS MCs) and Institutions for Occupational Retirement Provision (IORPs); and
- Financial advisers – including insurance intermediaries and undertakings advising on IBIPs, as well as **credit institutions**, investment firms, AIFMs and UCITS MCs **which provide investment advice (as defined by MiFID II)**.

The Regulation introduces a range of new definitions, including for concepts such as Sustainable investments, Sustainability risks and Sustainability factors.

- **Sustainable investments** - investments in an economic activity that contributes to an E or S objective, provided that they also do not harm any E or S objectives, and that the investee companies follow good governance practices.
- **Sustainability risks** – E, S or G event or condition that could cause an actual or potential **material negative impact on the investment's value** arising from an adverse sustainability impact.
- **Sustainability factors** – environmental, social and employee matters, anti-corruption and bribery matters and respect for human rights.
- **Financial products** encompass AIFs, IBIPs, pension products, pensions schemes, PEPPs, UCITS and portfolios managed per the definition under MiFID II.

Entities in scope of the Regulation will have to provide a range of disclosures on their **websites**, in **pre-contractual documentation** and through **periodic reporting**, specifically on:

Website;

- Sustainability risk policies
- Adverse sustainability impacts of investment decisions on sustainability factors at entity level
- Remuneration policies in relation to the integration of sustainability risks into investment decisions

Pre-contractual documentation:

- Integration of sustainability risks into investment decisions
- Adverse sustainability impacts of investment decisions on sustainability factors at financial product level
- Financial products promoting environmental or social characteristics
- Financial products with objectives of sustainable investing

Website and periodic reporting:

- Financial products promoting environmental or social characteristics or an objective of sustainable investment

European supervisory authorities are expected to develop regulatory technical standards (RTS) on the details of the presentation and content of the required disclosure - 12 months after the Regulation enters into force (i.e. **around November 2020**).

Low-carbon benchmarks

Low-carbon benchmarks are being created in order to support the transition to a low-carbon sustainable economy, by making it easier for investors to select a climate-conscious investment strategy. While a plethora of low-carbon indices already exist in the market, they have widely varying levels of ambition and differing strategies. Therefore, there arose a need in establishing minimum standards to address potentially illegitimate claims by administrators (e.g. investment companies) about the low-carbon nature of their benchmarks. Furthermore, in the absence of a harmonised framework to ensure the accuracy and integrity of the main categories of low-carbon benchmarks, there is a risk that differences in Member States' approaches would create obstacles to the smooth functioning of the internal EU market.

In March 2019, the European Parliament in its plenary session approved the [agreement¹²](#) on low-carbon benchmarks as part of the broader Benchmark Regulation. We expect the text to be published in the Official Journal of the EU in October 2019, with the Regulation entering into force at the earliest at the beginning of November (compliance with the Regulation – by 31 December 2021).

This agreement creates two new categories of voluntary **low-carbon benchmarks**, which administrators are eligible to market only after they have ensured compliance with criteria summarised below:

- **EU climate transition benchmarks**, aiming to lower the carbon footprint of a standard investment portfolio. Benchmarks in this category should be determined as taking into account companies in the investment portfolio that follow a measurable, science-based "decarbonisation trajectory" by end-2022, in light of the long-term global warming target of the Paris Climate Agreement.
- **EU Paris-aligned benchmarks**, which have the more ambitious goal to select only companies in the investment portfolio that contribute to achieving the 2°C reduction in global average temperature set out in the Paris agreement.

For other significant bond and equity benchmarks (in addition to the benchmarks detailed above but except for interest rate and currency benchmarks), the benchmark administrator must publish detailed information on whether or not, and to what extent, an overall degree of alignment of reducing carbon emissions, or, attaining the long-term global warming targets of the Paris agreement, is ensured. Furthermore, administrators should publish their calculation methodology, explaining the parameters applied, the type and source of data used, and how the benchmark contributes to environmental objectives.

Via delegated regulation, the Commission will specify the minimum content of disclosure obligations that administrators will be subject to when producing benchmarks belonging to the two categories detailed above. Additionally, the Commission will specify the minimum standards for harmonisation of the methodology for the two categories, including a method for the calculation of carbon emissions. The Commissions will run public consultations during its preparatory work on each of the respective delegated acts.

Prudential aspects of Sustainable Finance

Over the course of negotiations for the Revised Capital Requirements Regulation (CRR2) (2016-2019), legislators were keen to ensure that banks took into account emerging risks from climate change. The discussions were focussed on the banking book and loans to "green assets". One consideration was to introduce a 'Green Supporting Factor' (GSF) and a 'Brown Penalising Factor' (BPF) in order to incentivise banks as a Pillar 1 measure to decarbonise their balance sheets and push them towards more sustainable investments in future. In the end legislators decided not to pursue these proposals but gave the EBA several

¹² http://www.europarl.europa.eu/doceo/document/TA-8-2019-0237_EN.pdf

mandates to look at how climate risks and ESG factors could be addressed in the supervisory review and evaluation process (SREP) and stress-testing alongside other measures i.e. in the Pillar 2 framework. Since then we understand that national and European regulators are simultaneously exploring how stress-tests could take climate related risks into account with a view to doing so in advance of the EBA mandates being developed.

Pillar 2 approach/Stress-testing for climate-change related risks

We understand that a number of Supervisors and Regulators have committed to looking at how climate-related risks can be incorporated into stress-testing. At present AFME is aware of the following initiatives to do so:

- In April 2019, the Network for Greening the Financial System (NGFS), which consists of 36 Central Banks and Supervisors that share best practice in green finance, held a conference and issued its [first comprehensive report¹³](#) on climate change as a source of financial risk. During the conference, Supervisors expressed an intention to introduce stress-tests for climate-related risks in the near future.
- In April 2019 the Prudential Regulation Authority (PRA) also issued a [supervisory statement¹⁴](#) setting out specific governance, disclosure and ICAAP expectations in relation to climate risks and for firms to run 'scenario analysis'.
- According to a recent press release from the IMF¹⁵, the central bank of the Netherlands (De Nederlandsche Bank) has already undertaken stress-tests on climate-related risks.
- The EBA will look to incorporate climate-related risks into its SREP guidelines though it was noted this would not be part of SREP process in 2020. It will start its work with a survey of banks on current practices in this area over the course of summer 2019.
- Likewise, the ECB is also undertaking a survey related to climate risks.

While it is not expected at present that CRR3 will propose Pillar 1 measures such as a GSF or BPF, given the taxonomy is still under development, legislators may consider changes to the Pillar 2 framework such as stress-testing, given this is already under way in some Member States. Furthermore, the Commission has committed to addressing the climate change and sustainability challenge, including a prudential angle, within the next EU mandate.

Conclusions and Next Steps

AFME welcomes the progress made by EU legislators and policymakers on implementing the Sustainable Finance Action Plan and working towards a more sustainable, low-carbon and climate resilient economy. These are aims which AFME is fully committed to. We believe that the EU Taxonomy Regulation is fundamental in order for the Action Plan to deliver on its objectives. We think that now there is strong momentum and a need for market participants across industries to take a coordinated approach to ensure that the taxonomy can become a widely accepted, practical and effective tool to truly encourage the transition to more sustainable investment. Additionally, operationalising the new disclosure and low carbon benchmark regulation requirements though Level 2 legislation will be pivotal in achieving the objectives set by the regulations.

¹³ https://www.banque-france.fr/sites/default/files/media/2019/04/17/ngfs_first_comprehensive_report_-_17042019_0.pdf

¹⁴ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319>

¹⁵ <https://www.imf.org/en/News/Articles/2019/04/10/sp04102019-stress-testing-for-the-transition-to-a-low-carbon-economy>

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About AFME

AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.