EXPERT OPINION

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EUROPEAN FINANCIAL PLAYERS FACING THE NEW REQUIREMENTS OF EXTRA-FINANCIAL TRANSPARENCY

- SFDR & Article 29 of Energy-Climate Law -

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Introduction

In March 2018, the European Commission unveiled its action plan for sustainable finance. The creation of a Green Asset Taxonomy, the development of Green Bonds Standards and "sustainable" financial indicators were, among others, part of the ten announced actions. The desire to increase transparency on the taking into account of sustainability factors in investment decisions has resulted in the publication of the so-called "Sustainability-Related Financial Disclosure" regulation (EU 2019/2088 SFDR), which came into force on March 10, 2021.

In parallel with European requirements, Article 29 of the new French energy-climate law reflects France's ambition to maintain its lead in sustainable finance. Indeed, this article complements the European SFDR regulation by reinforcing the content of the extra-financial reporting to be published, formerly known as the "173 Report" in reference to article 173-VI of the The Energy and Ecological Transition for Climate (TEEC) law. Its decree, which came into force on May 28, 2021, encourages better integration of climate and biodiversity issues into risk management and investment decisions.

Through this expert opinion, I Care wishes to explore how financial players have appropriated these new regulations, particularly with regard to the scope of application and the positioning of financial products between Articles 8 and 9. Some of the operational difficulties encountered by financial actors, particularly with regard to indicators and data availability, will also be addressed.

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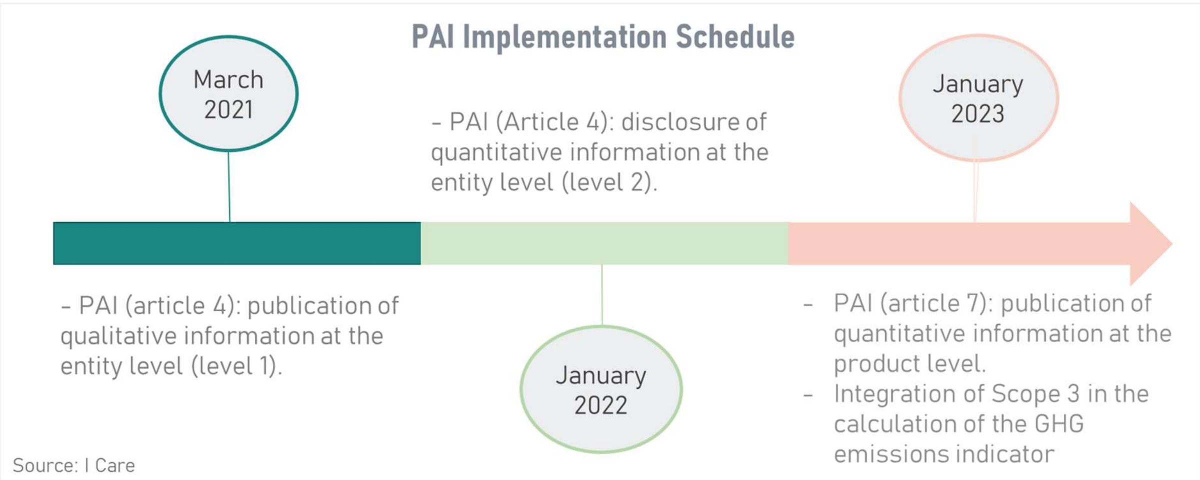
1 To which players do these new transparency requirements apply?

Gaps in the European regulation, which came into force before its delegated acts were published, have led financial players to make interpretative choices regarding the scope of application, as illustrated by the following examples.

The SFDR regulation aims to increase the transparency of the investor towards his clients on its management practices in order to avoid the risks of "greenwashing". Several of its articles aim to standardize the extra-financial information contained in the pre-contractual documents of the products, which must, according to the French Financial Markets Regulator, be kept up to date throughout their lifetime. Nevertheless, some management companies are questioning the need to deploy resources to update the pre-contractual documentation of products whose fundraising has ended and which are therefore no longer marketed.

The SFDR regulation also invites players to publish on their website the objective or characteristics of ESG products as well as the methodology used to assess them. However, to date, no details have been provided concerning private funds or management mandates, which must be kept confidential. Some players have therefore chosen to publish information on "families" of funds that share the same type of objectives, while others have preferred not to communicate anything until further details are available. The latest information published by the European Supervisory Authorities (ESA)[1] in July confirms this first solution by authorizing the publication of information on standardized products.

The inclusion of the principal adverse impacts (PAI) of investments on sustainability factors, a new feature introduced by Articles 4 and 7 of the SFDR regulation, is also subject to interpretation. The statement on due diligence policies regarding PAIs, mandatory from June 30, 2021, is optional for actors with less than 500 employees. It will therefore be an ambitious policy decision in this area for the most committed players. The declaration, tolerated in a non-detailed format in 2021, will commit actors in a more binding way to provide 16 quantitative indicators as soon as the next Regulatory Technical Standard (RTS) comes into force.



Is it better to commit now, even though it is difficult to assess the resources that will be needed to publish such indicators? The strategy adopted by the players will depend essentially on their

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[1] *Question related to Sustainable Finance Disclosure Regulation 2019/2088*, ESA, July 14, 2021, available here.

appreciation of the competitive advantage that will result from the publication of the PAI. The same will be true when PAIs are published at the product level in a second phase.

2 How to define whether a financial product must comply with Article 8 or 9?

As a reminder, Article 8 of the SFDR Regulation applies to financial products that "promote environmental or social characteristics" while Article 9 applies to those that "have sustainable investment as their objective". Both articles require financial actors to disclose information on how the ESG characteristics or the sustainable investment objective are met. Although this regulation provides a definition of "sustainable investment" for the first time, the lack of precision in these two articles has led to different levels of interpretation. The only consensus is on the extension of sustainability risk integration to all types of management (Article 6), which should not be a sufficient element for the product to be subject to Article 8.

Management companies have had to make their own trade-offs when classifying their funds under Article 6 (non-ESG), Article 8 (ESG) and Article 9 (sustainable investment). But it would seem that the approach adopted is not representative of the management team's level of commitment. While "caution" has led some to interpret the articles very strictly, identifying a minimum number of funds as article 8 or 9, it has pushed others to a broad interpretation that has allowed a large number of funds to qualify for reasons that are essentially commercial and linked to the real or anticipated pressure from their institutional investors. Aware of these discrepancies, some players have already adapted their initial interpretation, which is still likely to change following the clarifications provided by the latest ESA publication in July.

A study conducted by Morningstar, published at the beginning of April 2021, analyzed the prospects of 30 asset management companies of different nationalities and sizes. It showed that 21% of the European funds met the criteria of article 8 and 9.

Proportion of article 8 and 9 funds of Asset Managers, Morning star, April 2021

It is not surprising that the implementation of a directly applicable regulation, which is both structuring and still incomplete on certain points, should result in divergent interpretations by the players concerned. In a very promising commercial context for sustainable products, the inflation of funds classified under Article 8 may lead to less rigorous integration of ESG characteristics. It is desirable that European regulators contribute to the harmonization of the interpretations adopted by the players.

3 Which indicators should be used to meet this new transparency requirement?

In order to meet the new regulatory requirements, financial actors must identify and mobilize the most relevant indicators for their type of products, taking into account their clients' expectations.

The use of ESG indicators[2], already widespread in the management of sustainable investments, will be extended to the management of traditional financial products in order to be able to justify *the taking into account of sustainability risks* (art. 4 of the SFDR). Many financial players are already starting to educate their management teams on this subject, to recruit dedicated analysts or to find service providers to outsource this analysis.

- **The increasing use of climate indicators**

While still less common, climate indicators are starting to be used more often in non-financial reports. Article 29 of the Energy-Climate Law requires transparency on the alignment of portfolio temperatures with the 2°C scenario defined by the Paris Agreements. In order to meet this obligation, players have a vast choice of indicators with often varied results, depending on the methodological choices made, such as the type of allocation[3] and alignment[4], the reference scenario used by the methodology or the time frame studied. Another parameter explaining the difference in results concerns the scope studied, with the choice of whether or not to include *scope 3*[5] still being debated.

For example, the *SB2A* indicator measures a company's GHG emissions in terms of physical intensity (GHG emissions/production unit), whereas the *MSCI Warming Potential* indicator measures these emissions in terms of economic intensity (GHG emissions/€ of turnover)[6]. Although simpler to calculate, the latter is less rigorous since the economic value of a good is not proportional to its climate performance. A sport car with higher greenhouse gas emissions than a conventional car will nevertheless have a better economic efficiency.

- **The development of biodiversity indicators**

The recent rise in the measurement of the impact of investments on biodiversity, addressed by Article 29, is forcing financial actors to innovate in the measurement of the biodiversity footprint, the first indicators of which are beginning to emerge. The *Corporate Biodiversity Footprint*, for example, makes it possible to calculate the impacts on biodiversity of economic activities along the entire value chain, with an integrated approach over time. The *Global Biodiversity Score* covers more pressures (notably on aquatic biodiversity) but adopts a non-integrated approach over time

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[2] Environmental, Social and Governance indicators such as carbon emissions (E), gender parity and equal pay, working conditions, respect for human rights and fundamental freedoms (S), independence of the Board of Directors (G).

[3] The type of allocation corresponds to the level studied: the entire economy, the sector of activity or the company.

[4] The type of alignment corresponds to a static or dynamic approach to the performance of a financial player in relation to a given scenario.

[5] Scope 3 includes all other greenhouse gas emissions that are not directly linked to the manufacture of the product, but to other stages of the product's life cycle (supply, transport, use, end of life, etc.).

[6] Comparative study of 2°C indicators, Louis Bachelier Institute and analysis, 2020.

with two indicators of stocks and flows of impacts on biodiversity[7]. These two tools use the same unit, the MSA.km², which measures the average abundance of native species as a percentage of the original natural state of the ecosystem[8] over a given area. The *Biodiversity Footprint Financial Institutions (BFFI)* method, whose tool is still in the development phase, uses a life cycle analysis approach based on the ReCiPe[9] method.

Like the TCFD for climate, the Taskforce on Nature-related Financial Disclosure (TNFD) was recently launched to provide a framework for organizations to clarify biodiversity risk trends and redirect global financial flows to investments that benefit nature by 2023. The international alignments mentioned in article 29 have been published in the form of 21 targets to be reached by 2030 and will have to be approved at the COP15. The latter was supposed to be held in China in October, but the event has been postponed again to Q2-Q3 2022 due to the global Covid-19 pandemic.

- **The creation of an overall environmental indicator: the green share**

The articulation between the SFDR regulation and the European Taxonomy of Green Activities marks the appearance of a new environmental indicator. From 2023[10], investors and companies will be obliged to measure the environmental performance of their activities and to publish their "green share". This indicator corresponds to the percentage of the turnover of companies whose activities respect the thresholds defined by the European taxonomy for each sector. It allows several environmental impacts to be taken into account within a single indicator (as is the case with the NEC[11]), since the taxonomy covers climate, water consumption, biodiversity, the circular economy and pollution risks.

This benchmark, which is very useful in the fight against green washing, is however difficult to implement on an operational level. The limits of the technical criteria, in particular DNSH[12], can be seen when they are applied to the company's actual activities. The extreme granularity of the necessary data makes it necessary to send targeted questionnaires to companies for the time being. Moreover, the binarity of the result - green or not green - highlights the best practices by sector but does not take into account other activities that are also, to a lesser extent, beneficial for the environmental transition. It will certainly take a few years to reduce the margin of interpretation possible to date and stabilize the application of this regulation.

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[7] The stock indicator measures all biodiversity losses related to the activity since its start, while the flow indicator measures all losses related to the activity during the assessment year.

[8] MSA : Mean Species Abundance

[9] The main objective of the ReCipE methodology is to transform the numerous results of the life cycle inventory into a limited number of indicator scores. These express the relative gravity of an environmental impact category. The unit used is the PDF.m2.an where PDF stands for *'Potentially Disappeared Fraction of species'.*

[10] The alignment to the Taxonomy should be published in 2023 for companies and 2024 for financial actors according to the delegated act on article 8 of the European Taxonomy.

[11] The NEC (Net Environmental Contribution) is an indicator developed by I Care in partnership with Quantis and Sycomore.

[12] *Do not significantly harm* criteria aims to verify that the positive impact of the activity on one of the six objectives of the European taxonomy does not have a negative impact on another objective.

Regulatory requirements	Examples of indicators	Maturity of methodologies	Implementation difficulties
ESG and Sustainability Risk Integration *SFDR*	*E - Carbon emissions, water consumption, air pollution etc.* *S - Safety at work, gender equality, equal pay, etc.* *G - Independence of management bodies, key-man risk, etc.*	Stabilized	• Difficulty quantifying the financial impact of transition risks and opportunities • Need for resources: training on ESG risks, recruitment of dedicated analysts or data providers • 16 PAI indicators awaiting confirmation
Strategy for alignment with the Paris Climate Agreement *Article 29 LEC*	Carbon footprint	Stabilized	• Different results depending on the scope, type of allocation, type of alignment, scenario used and time horizon studied, which complicates the comparison between two assets or two portfolios • Lack of consensus on the inclusion of scope 3
	2 degree alignment: SB2A, MSCI Warming Potential etc.	Stabilized	
	Physical and transition risks	Operational	
Alignment of activities to the European taxonomy *SFDR*	Green share	Under operational adjustment	• Complex technical criteria that are difficult to apply operationally • Targeted questionnaires required to obtain the required level of data aggregation.
Alignment with international biodiversity targets *Article 29 LEC*	Corporate Biodiversity Footprint	Recently commercialized but still in development	• Lack of experience in calculating the biodiversity footprint • Necessary data rarely calculated by companies
	Global Biodiversity Score		
	BFFI	In development	

Maturity and operational difficulties of available indicators to meet regulatory requirements, I Care, 2021.

Finally, the SFDR regulation introduces for the first time the consideration of the main negative impacts of investments on sustainability factors. This impact measurement requires the monitoring of 16 indicators defined by the RTS[13]. These concern GHG emissions, but also water, waste and biodiversity, as well as social factors such as gender equality and labor rights. It is essential for financial actors to acquire the right tools now, which will allow them to use the measurement of these indicators as a differentiating asset by taking them into account in company management, rather than simply suffering the costs generated by their measurement.

4 What are the barriers to accessing data?

After identifying and selecting the most appropriate indicators, players face a final challenge: the availability of company data. The ease of access to this information differs significantly depending on the investment universe and the influence of financial players.

The sector of activity, the origin and the size of the company have a strong impact on the availability of data. Large European companies are subject to an obligation to declare their extra-financial[14] performance, which makes the data easily accessible to investors, whereas information concerning a small or medium-sized company established in a less regulated country is more difficult to collect. In this respect, the revision of the Non-Financial Reporting Directive (NFRD), whose scope is to be extended to all companies with more than 10 employees[15], should make it possible to meet investors' needs for access to extra-financial data from the smallest companies. Companies in the most polluting sectors are also showing a tendency to publish more information about their activities in order to respond to growing pressure from investors.

[13] Regulatory Technical Standards equivalent to an implementing decree, according to the latest version of the Draft Report published on February 4, 2021.
[14] *DPEF: Déclaration de performance extra-financière*, French transcription of the NFRD.
[15] Latest CSDR proposal for a directive on corporate sustainability reporting to amend the NFRD, dated 21 April 2021. Online consultation available here.

A European database?

The European Commission's ambition is to propose a single access point for regulated information, which would gather information published by all European listed companies: the ***European Single Access Point (ESAP)***. This public database would make it possible to centralize financial and non-financial information and to facilitate access to data at a lower cost, for all investors and other interested stakeholders.

A questionnaire on the creation of the *ESAP* has been submitted for consultation in the first quarter of 2021 in order to ask the market about the creation of such a database. This follows the recommendations made by the *High-Level Forum on the Capital Markets Union* in June 2020.

The size of the financial player and the nature of its investments also allow it to access the company's information more or less easily. The largest financial players have more internal financial and technical resources to collect and process the data themselves, for example by sending out questionnaires or gathering information from dedicated suppliers. The lack of resources of some investors therefore contributes to the fragmentation between ambitious investors, capable of providing the necessary data, and investors who are cautious due to lack of visibility. On the other hand, shareholders have a privileged relationship with the company and more influence to demand more transparency from the company than a creditor or an investor in the derivatives markets. However, as the *Inter-American Development Bank* points out in a recent report on sustainable bond issuers[16], the integration of ESG risks is progressing and will also soon become the norm for bond market investors, despite the lack of a common methodology to date.

Conclusion

Since March 10, 2021, investors face new regulatory requirements stemming from the SFDR regulation. The overlapping regulatory timetables and the uncertainties of the texts may cause difficulties in the classification of products and the adaptation of the management model of financial players. Some are tempted to wait for the publication and entry into force of the RTS, which will specify the granularity of the information required to integrate environmental indicators into their investment strategy and develop an appropriate methodology. The European Commission has indicated to the co-legislators its intention to postpone the entry into force of the RTS until July 1, 2022[17], which should prolong the period of doubt regarding their interpretation. In addition to the general information in the SFDR regulation, the setting of prospective quantitative targets and the quantification of physical and transitional risks are also expected by the Article 29 decree.

Despite difficulties in its implementation, the regulatory framework has made it possible to place sustainability factors at the heart of the concerns of financial actors. Alongside the environment, the social aspect remains one of the European Commission's key issues and should be developed in the near future. Its objective of placing environmental, social and governance issues at the same level in the context of the revision of the NFRD should make it possible to align the levels of ambition of issuers, investors and public decision makers. However, the interim report on the development of a social taxonomy[18] published in July has raised some concerns, as social issues are currently regulated between the social partners at member state level. The appropriation of

[16] Sustainable Issuer versus Sustainable Issuance, IDB, 2021. Online consultation available here.

[17] Reuters article, "EU further delays sustainable finance rules for asset managers", published on July 9, 2021. Online consultation available here.

[18] Draft report for a social taxonomy published on July 12, 2021 on the Sustainable Finance Platform. Online consultation available here.

this subject by the European Union would make it possible to homogenize national standards in an international market context, with a particular focus on the development of quantitative criteria, which could prove more complex than for environmental issues. The stabilization of this comprehensive and ambitious system will obviously take several years.

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