EACT Briefing

Sustainable Finance

THE EUROPEAN ASSOCIATION OF CORPORATE TREASURERS

Sustainable finance and environmental, social and governance (ESG) reporting are becoming increasingly important topics for treasurers. The regulatory developments at European Union (EU) level relating to sustainable finance will result in a reorientation of capital market funding. They will also impact bank lending to the economy.

This briefing will shed light on why and how sustainable finance should matter to all treasurers and explain the latest regulatory developments and initiatives at EU level.

We are grateful to the members of the German Association of Corporate Treasurers' (VDT eV.) working group Equity & Debt who contributed to this publication.

For more information, please contact:

Tarek Tranberg
Head of Public Affairs & Policy
European Association of Corporate Treasurers – EACT
tarek.tranberg@eact.eu

EU Sustainable Finance Regulation

Why it matters for Corporate Treasury

Context

Flowing from a 2018 action plan of the European Commission (EC), the regulatory and political agenda on sustainable finance has become an essential element of the EU's objective of becoming the first climate-neutral continent by 2050.

Sustainable finance is in this context viewed as one of the enabling elements of the overarching European Green Deal that will ensure the necessary channelling of private investment and capital to fill the EU's investment gap and enable the EU to meet the objectives of the COP21 Paris Agreement accords.

From a corporate treasury perspective, the sustainable finance agenda is important because the parameters of what is considered sustainable, which are being defined at the moment, coupled with the new disclosure obligations that have been introduced/are planned for introduction, will result in a significant reorientation of capital flows.

In concrete terms, beyond how a company is perceived by financial markets, businesses are likely to experience changes – for better or worse – to their funding conditions and their interaction with capital markets as issuers.

With ESG criteria being integrated into investment products that are marketed as sustainable and with a growing demand for ESG investment globally, investment flows will be increasingly directed away from companies that are viewed as less sustainable or on a lower sustainability trajectory than expected.

The EC will double down on advancing initiatives in this policy area and is expected to come forward with its Renewed Sustainable Finance Strategy later in Q4 2020. The strategy will contain elements that will venture further into the non-financial corporate space, covering – amongst others – topics such as green loans and bonds, corporate disclosure, ESG data, ratings, and research, as well as ESG metrics in credit ratings.

Illustrated below is a subset of the regulatory initiatives that are planned or are underway as part of this agenda.

Reorienting capital flows towards a sustainable economy

The Taxonomy Regulation

Primary legislation is in place, with more work being done on secondary legislation. Disclosure obligations to be phased in from end 2021.

The EU sustainable taxonomy is intended to become the EU's shared dictionary of what economic activities are to be considered sustainable. For economic activities to be considered as aligned with the EU taxonomy, they must contribute positively to one of the six high-level environmental objectives. The high-level objectives determined by the Taxonomy Regulation are:

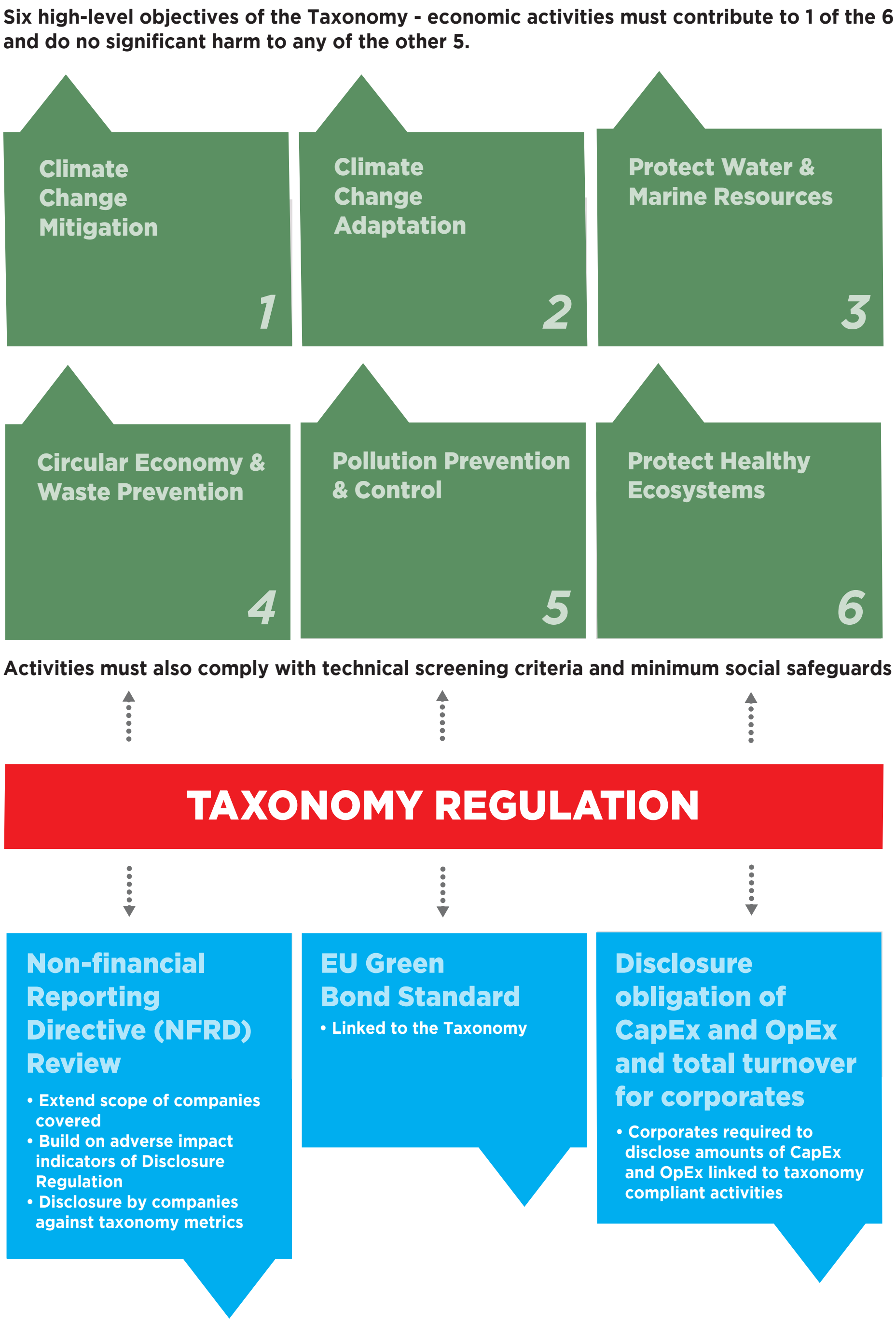
- Climate change mitigation,
- Climate change adaptation,
- Water and marine resources protection,
- Circular economy and waste prevention,
- Pollution prevention and control, and
- Protection of healthy ecosystems.

Economic activities must meet at least one of the objectives and cause no significant harm to any of the other five. At the same time, the activity needs to comply with technical screening criteria and with the minimum social safeguards (OECD Guidelines for Multinational Enterprises; the UN Guiding Principles on Business and Human Rights; the International Labour Organisation's Declaration on Fundamental Principles and Rights at Work; and the International Bill of Human Rights).

The technical screening criteria will be applied by the EC in implementing legislation – so-called Delegated Acts that specify technical elements laid down in the main legislation. The first of these Delegated Acts that will specify the technical screening criteria for climate change mitigation and adaptation will be finalised by the end of 2020 and enter into force by the end of 2021.

The Taxonomy also introduces disclosure requirements for financial market participants – depending on the product offered – and for non-financial companies that are within the scope of the EU's Non-Financial Reporting Directive (NFRD). For financial products, financial services providers will need to disclose whether they have taken the Taxonomy into account. Where a product is advertised as sustainable, market participants will need to disclose which objectives and criteria are being pursued with the product.

The disclosure obligation for corporates requires that non-financial statements (i.e. disclosure in annual reports of information regarding the way the company operates and manages social and environmental challenges) include information on whether the reporting entities' activities are associated with environmentally sustainable economic activities. Corporates in scope of the NFRD will also need to disclose the share of their turnover that is derived from products or services associated with environmentally sustainable activities, as well as the share of total investments (CapEX) and/or expenditures (OpEX) that is linked to Taxonomy compliant activities. Currently in scope of the NFRD are corporates which have more than 500 employees and are publicly listed. This scope, however, is likely to be extended with the upcoming review of the NFRD to also cover non-listed companies and those with fewer employees than 500.



Ecolabel for financial products

This is currently being designed by the EU Commission's Joint-Research-Centre.

The EC is focused on developing an EU Ecolabel framework that would serve as a 'best-in-class label' for certain financial products. At present, this would be targeted at those that are included in the packaged retail investment and insurance products (PRIIPs) framework, as well as fixed-term deposit or savings deposit vehicles. The focus of the label would be on the extent to which the assets underlying the financial product are linked to environmentally sustainable activities as defined by the Taxonomy Regulation. The EU Ecolabel for financial products is meant to be a voluntary label that sits alongside other existing frameworks.

EU Green Bond Standard (EU GBS)

EU legislative proposal in Q4 2020/Q1 2021

In the coming months (Q4 2020-Q1 2021), the EC is expected to table a proposal for the creation of a voluntary EU Green Bond Standard (EU GBS) that is linked to the Taxonomy Regulation. The driver behind this is to facilitate access by investors to products that meet their sustainability objectives by being able to refer to a uniform standard for Green Bonds.

The EU GBS would exist in parallel to other standards – e.g. the ICMA Green Bond principles – as its use would likely remain voluntary rather than mandatory. That said, policymakers hope that the creation of an EU GBS that is linked to the Taxonomy would result in enough uptake, so as to become the standard label of reference. One advantage of the EU GBS concept that is currently proposed by the EC is that it requires issuers to develop an overall green bond framework but allows for multiple bond issuances under the same framework. Issuers would then be required to only compile one single allocation report (requiring external verification) for all issuances under the same framework.

Policymakers hope that the creation of a standard will reduce some of the labour intensity associated with green bond issuance and render the asset class more attractive to issuers. The proposed EU GBS is also meant to streamline the allocation, reporting, and verification processes for issuers.

Integration of sustainability concerns in stress testing and prudential requirements of financial institutions

Integration in stress testing is already happening. EU prudential rules (Basel III package) to be proposed in Q4 2020

For insurers and for banks, the EU supervisory authorities European Institutional and Occupational Pensions Authority & European Banking Authority have either indicated that they would or already have integrated ESG factors into their stress testing of banks and insurers, with a view to identifying vulnerabilities to climate-related financial risks.

It is also likely that during the upcoming legislative discussions on implementation of the latest Basel standard for bank capital requirements at EU level through new amendments to the Capital Requirements Regulation (CRR) and Directive (CRD), policymakers will consider the question of whether to introduce either a green supporting factor or a brown penalising factor.

A green supporting factor would provide for a more beneficial capital treatment for bank exposures that are considered more sustainable (potentially aligned with the EU Taxonomy), whereas a brown penalising factor would add capital surcharges to exposures that would be considered less sustainable or not in line with the EU Taxonomy. Either approach would likely result in a readjustment and repricing of corporate lending and risk management through derivatives.

With the EU indicating that economic recovery from the Covid-19 pandemic will need to double down on meeting the objectives of the European Green Deal, this could lend further support to potential moves by policymakers to introduce such factors. At the same time, some banks (both public and private) are already applying pressure to the non-financial sector by indicating that 'brown' industries or companies will not be financed or financed only with punitive surcharges.

Moving forward, it is likely that shareholders and investees in large lenders as well as asset managers will apply pressure on lenders to reduce or eliminate exposure to industries and companies that are considered unsustainable.

Sustainable finance in derivatives markets

An impact is also likely to be felt in derivatives markets. This will be as a result of greater transparency and disclosure obligations for both financial institutions, as well as for corporates, on the extent to which ESG strategies have been pursued or whether the business activity is in line with the EU Taxonomy.

Today there are already ESG-specific derivatives offerings. However, building on a proliferation of ESG disclosure in the coming years, it is likely that ESG considerations and metrics will play a more significant role in the pricing of derivatives. From a corporate perspective this would be in relation to both those derivatives that banks would sell to corporates, but also any hedging instruments (e.g. Credit Default Swaps) that banks would take out against corporate exposures.

Much in this context would then depend on whether the underlying of a derivative is considered more or less sustainable on the basis of the information disclosed to the market and the overall alignment with the EU Taxonomy.

Heightened transparency requirements

Disclosure Regulation

EU primary legislation is in place, more work on secondary legislation ongoing.

The Disclosure Regulation introduces disclosure obligations for financial market participants[1] on policies related to sustainability risks and their integration in investment decision-making and remuneration policies. The Regulation further requires disclosure of due diligence policies on the adverse impact of investment decisions on environmental, social and employee matters, The Regulation will also require disclosure of adverse impact on a product level and disclosure of how sustainability objectives of an investment product are met if it is marketed as sustainable.

DISCLOSURE REGULATION

- **Obligation for financial market participants to disclose ESG integration in investment decisions and remuneration**
- **Disclosure of adverse impact at financial product level**
- **Disclosure of adverse impact of investment decision in relation to companies being invested in (Link to NFRD Review)**

In secondary legislation – Regulatory Technical Standards – that accompanies the Disclosure Regulation, and which is currently being finalised, the principle of "adverse impact" and its indicators are being developed. The secondary legislation in its current draft form introduces detailed indicators that financial market participants would need to disclose information against in relation to the companies they invest in. The granularity of the indicators will likely require a significant increase in the information being disclosed by investee companies.

[1] Financial market participant means: an insurance undertaking which makes available an insurance based investment product (IBIP); an investment firm which provides portfolio management; an institution for occupational retirement provision (IORP); a manufacturer of a pension product; an alternative investment fund manager (AIFM); a pan European personal pension product (PEPP) provider; a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013; a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013;a management company of an undertaking for collective investment in transferable securities (UCITS management company); or a credit institution which provides portfolio management;

The European Supervisory Authorities - EBA, EIOPA and the European Securities and Markets Authority (ESMA) - will submit the final draft technical standards to the EC by the end of 2020. These standards could enter into force in H1 2021.

Non-Financial Reporting Directive (NFRD) framework

EU legislation to be proposed in Q1 2021

The Non-Financial Reporting Directive (NFRD) requires large public interest entities (listed companies, insurers and banks with more than 500 employees) to disclose diversity and non-financial information related to environmental, social, employee and human rights aspects as part of their management or annual report. The legislation provides for significant flexibility in the manner in which the information is disclosed.

The EC will propose a review of the NFRD in Q1 2021 in the form of a Regulation on Non-Financial Reporting, which is expected to increase the scope of corporate entities that are subject to the disclosure requirements. The new Regulation is also likely to build on both the adverse impact indicators being developed under the Disclosure Regulation and the thresholds and indicators that are being developed under the Taxonomy Regulation and require transparency by companies regarding the information that corresponds with the relevant indicators.

This in turn would ensure that investors have available to them all the necessary information to meet their disclosure obligations in relation to their products and investment strategies.

Credit Rating Agencies' (CRAs') integration of ESG and sustainability ratings

Potential EU initiatives – including legislative changes from 2021 onwards

The EC has investigated the extent to which integration of ESG criteria into credit ratings could be made mandatory. ESMA has advised against doing so, but there are open questions as to whether a transparency obligation should be introduced for credit rating agencies regarding the extent to which ESG criteria have been included in their credit-rating decision.

Linked to this is the question of regulatory treatment for specialised sustainability rating providers, which at the moment are not subject to a harmonised licensing regime. Equally, there is no standardised methodology for the development of sustainability ratings, with different providers using different data points and weighting.

The EC is due to present the findings of a study it has conducted into the market for sustainability ratings later this year.

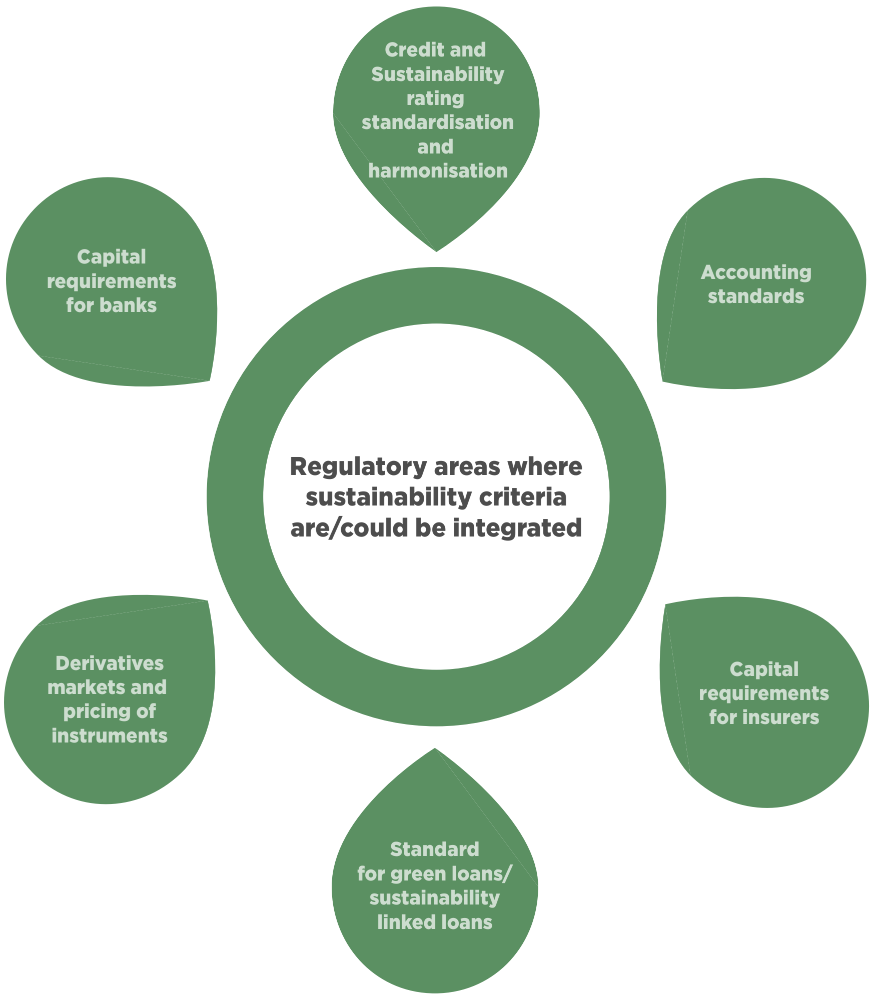
Integration of sustainability criteria in Accounting Standards

2020 onwards

Another open question will be how sustainability considerations are incorporated into accounting standards and whether any new accounting rules would leverage existing sustainability reporting standards, such as those developed by the Global Reporting Initiative (GRI) or the Sustainability Accounting Standards Board (SASB).

Future considerations – Renewed Sustainable Finance Strategy and Impact on Treasury

As part of the considerations as to how to take the EU's sustainable finance ambitions forward, the EU Commission will present a Renewed Sustainable Finance Strategy in Q4 2020. As part of the future work in this policy area there may be a renewed discussion on creating not only a taxonomy for activities that are considered sustainable, but also – in line with calls by supervisors such as the ECB – the creation of a so-called "brown taxonomy". This brown taxonomy would illustrate which economic activities are considered unsustainable, and could in turn, serve a further reorientation of capital flows.



As part of the initial consultation on the Renewed Sustainable Finance Strategy, policymakers also sought feedback on whether existing capital market infrastructure is well equipped to support an increase in issuance of sustainable securities, or whether policymakers should, through top-down regulation, create sustainable finance-oriented exchanges that support liquidity in this particular market segment.

Moving forward, policymakers will equally turn their attention to the creation of new standards or labels – for example green loans. A green loan label would function in a similar manner as the EU GBS and require that the activities being funded are aligned with the EU Taxonomy Regulation. The latter would be more restrictive than, for example, sustainability-linked loans, for which a market exists already today.

Impact on Treasurers

Whilst some of the new regulatory requirements being brought in do not directly impose new obligations on treasurers, they will severely affect the environment (both external and internal) in which treasurers operate. Treasury departments will very likely be called upon to assess and report internally how ESG factors are affecting the financial performance and health, as well as the financial outlook, of the company.

Equally, treasurers will have to coordinate more intensively with their sustainability colleagues to collect and centralise the information that will be required of them when accessing capital markets or requesting bank funding. Treasurers operating in the EU will have to familiarise themselves with the metrics and specifications of the EU's Sustainable Taxonomy, especially if they wish to issue green bonds, but equally as the Taxonomy will form the foundational basis of how the performance and viability of their company will be judged by the market.

Overall, all non-financial companies – irrespective of their sustainability profile – will need to be much more transparent with respect to their ESG transformation efforts in order to improve or maintain their capital and credit market conditions. Mandatory sustainability disclosure at EU level linked to the Taxonomy and potentially building on existing international sustainability reporting standards (SASB, GRI) will equally mean that there will be more widespread and standardised availability of sustainability information for capital and credit markets to judge individual companies' performance and future prospects.

With policymakers applying equal pressure on investors and lenders to integrate ESG metrics into their investment and loan portfolios, corporate sustainability disclosure will be much more than a box-ticking exercise and will require genuine adjustments to long-term business strategies.

THE
EUROPEAN
ASSOCIATION
OF
CORPORATE
TREASURERS

13,000+
PROFESSIONALS

23
NATIONAL TREASURY ASSOCIATIONS

6,500
COMPANIES REPRESENTED

EACT HEAD OFFICE
3 rue d'Edimbourg
CS 40011
F-75008 Paris
Email: secretary@eact.eu
Telephone: +33 1 42 81 53 98

www.eact.eu