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REGULATORY INTELLIGENCE

Surfeit of climate standards? EU ESG reporting rules uncertainty; UK follows TCFD

Published 10-Mar-2021 by
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Like vaccines, climate-related disclosure regulations are beneficial but take time to absorb. European and UK firms have had to digest several environmental, social and governance (ESG) rule changes since the introduction of the Non-Financial Reporting Directive (NFRD) in 2017. They are absorbing fresh obligations with more to follow. The pace of developments is causing complications.

On March 10, 2021, the EU's Sustainable Finance Disclosure Regulation (SFDR) comes into effect, introducing exacting ESG transparency rules for investment firms, pension providers and financial advisers. In brief, SFDR requires firms to publish information on how they integrate sustainability into investment decisions or advice. Those with more than 500 employees must also publish due diligence policies regarding their investment decisions' principal adverse impacts (PAIs) on sustainability factors. Smaller firms are under a similar obligation on a "comply or explain" basis.

"Financial advisers and financial market participants, including portfolio managers and fund managers,that are regulated in the EU or who market their products to EU-based investors, will have to make significantly enhanced disclosures related to ESG matters, including relating to climate change," said Simon Witney, a senior consultant at lawyers Travers Smith.

"The largest asset managers will have to take account of PAIs from June 30, 2021, but most will retain the option to explain that they do not take account of such factors."

SFDR is one leg of a tripod of new EU financial legislation, along with a pending revised NFRD increasing the amount of ESG information to be included in corporate annual reports and a Taxonomy Regulation creating a classification system for SFDR and NFRD sustainability disclosures, in force from last summer. They aim to tackle a "greenwash" problem besetting sustainable finance. Many ESG claims are hard to substantiate and the plethora of evaluation metrics in use makes comparisons hard. The tripod should improve the consistency, comparability and reliability of EU disclosures.

Commission to clarify areas of uncertainty

There are flies in the ointment, however. One is that the tripod seems a bit wobbly, perhaps because the EU announced big actions quickly and fretted about the detail later. Final draft regulatory technical standards (RTS) for SFDR were only published in February, just five weeks before SFDR implementation. Somewhat disconcertingly, shortly before issuing the RTS, the European supervisory authorities (ESAs) wrote to the Commission seeking urgent clarification of "several important areas of uncertainty in the interpretation of SFDR".

The ESAs' concerns included SFDR's application to non-EU alternative investment fund managers, the application of the 500-employee threshold for PAI reporting to groups' parent companies, the application of art 9 of SFDR and the definition of "promotion" in the context of products promoting environmental or social characteristics. These have yet to be clarified, but the RTS are not expected to come into force until January 2022.

"The ESAs do not have a legal mandate to clarify the areas of legal uncertainty that many market participants are concerned about, including, for example, when a product will be deemed to promote 'environmental or social characteristics'," Witney said.

"Some of draft RTS' recitals seek to provide some clarity on some issues, but guidance is expected from the European Commission. At least until that is available, the uncertainty will remain."

"Do no significant harm" principle

Article 2(17) of SFDR defines a "sustainable investment" as an investment in an activity that contributes to an environmental or social objective, provided such investments "do not significantly harm" any other environmental or social objective. Knowing what constitutes doing significant harm is therefore important, but SFDR provides no definition.

"The final draft RTS also do not provide a comprehensive [do no significant harm] definition, leaving firms some discretion to make an assessment," Witney said. "But they say that a firm will need to explain how it has used the indicators for PAIs, set out in an annex to the RTS, to determine whether an investment significantly harms any of the relevant objectives."

"In addition, the firm will have to explain whether the 'sustainable investment' is aligned with the [Organisation for Economic Cooperation and Development] Guidelines for Multinational Enterprises and the United Nations Guiding Principles on Business and Human Rights."

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The Taxonomy Regulation's criteria for whether an activity is environmentally sustainable contains a similar "do no significant harm" principle. A delegated act containing technical screening criteria on whether activities contribute to climate change objectives was to be adopted last December but has been delayed while the Commission seeks further advice.

Plethora of reporting frameworks

Another problem is that the tripod creates a separate EU reporting framework when ideally there would be an international standard. The creation of such an international standard is an EU ambition, but there are already several frameworks, including recommendations issued by the Financial Stability Board (FSB) Task Force on Climate-Related Financial Disclosure (TCFD).

Adding to the mix, the International Financial Reporting Standards Foundation recently consulted on establishing a Sustainability Standards Board which would initially prioritise climate-related reporting. The FSB urged it to use the TCFD recommendations as the basis of this work.

Whereas the TCFD approach focuses on climate change, the EU legislation covers a broad spectrum across ESG. For example, as part of NFRD revision, the European Financial Reporting Advisory Group is working on an EU non-financial reporting standard that includes social considerations. Some countries prefer the more limited approach.

The UK will not be onshoring SFDR, although UK firms should be aware of its requirements and the government is building on the Taxonomy Regulation to create a framework of environmental sustainability criteria. It plans to introduce mandatory reporting using the TCFD recommendations instead. A roadmap issued in November showed how this would be done, with most measures introduced by 2023.

"Unchartered territory"

From October, regulations under the Pension Schemes Act 2021 will require large UK occupational pension schemes to consider climate risks in their investment strategy and publish an annual report meeting TCFD recommendations. This will be a marked change from the current high-level regime, which requires funds to adopt and report against ESG investment policies where the fund decides they are relevant, said Andy Lewis, a pensions partner at Travers Smith.

"The new rules … will require much more specific and focussed action," Lewis said. "The new regulations have been designed to bring TCFD principles into pensions law and make compliance with the principles mandatory. This approach to TCFD is a first for the UK economy but we know the government is planning to roll it out to other sectors. The new requirements will capture large occupational pension schemes, collective DC schemes and master trusts, with a possible extension to smaller funds following a review in 2023/24."

Funds will also be required to carry out at least two types of climate scenario analysis to examine scheme resilience, plus set and regularly monitor at least three climate-related metrics. They must set a non-binding target for their scheme in relation to at least one of the selected metrics and measure performance against it annually. All of this will have to be publicly disclosed in a detailed annual TCFD report.

"This highly detailed and extensive set of new legal duties around climate change is going to be pretty unchartered territory for many pension funds," Lewis said. "The law is certainly ground-breaking and focussed on important policy goals. It will be interesting to see how effective the new regime turns out to be from a policy perspective. In practice, we are expecting it to be a significant compliance burden, especially in the early years."

Complaints Procedure

Produced by Thomson Reuters Accelus Regulatory Intelligence 10-Mar-2021

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