

FULL DISCLOSURE: MONTHLY BRIEFING ON EU CORPORATE TRANSPARENCY REGULATION
MAY 2021 ISSUE

The EU Sustainable Finance April package and how EU sustainability reporting standards fit in

For the transformation of the European economy to meet the EU's objective to reach climate neutrality by 2050, additional investments of half a trillion EUR every year are needed¹. To cover the investment gap, the EU strategy rests on two complementary lines of action:

1. an overhaul of incentives in financial markets and corporate governance (these are mainly tackled through the Sustainable Finance agenda² and the upcoming Sustainable Corporate Governance initiative³), and
2. transparency on both positive and negative impacts on sustainability by companies as well as providers of capital.

To get one step closer to this, the European Commission adopted a sustainable finance package on 21 April 2021⁴ covering the following measures:

1. A draft **Corporate Sustainability Reporting Directive** (CSRD⁵) (formerly Non-Financial Reporting Directive (NFRD⁶)) that addresses companies' obligations to report consistent and comparable key data on sustainability-related risks and impacts.
2. The **EU Taxonomy Climate Delegated Acts as part of the EU Taxonomy Regulation**⁷ which classifies sustainable activities (and specifies criteria and reporting requirements) for the purpose of sustainable finance.

¹ EU Commissioner McGuinness (2020): The state of EU environmental disclosure in 2020. <https://www.youtube.com/watch?v=T-oi2PAySGA&t=322s>. Last retrieved: 2021-04-16.

² European Commission (2021): Sustainable Finance. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en. Last retrieved: 2021-04-23.

³ European Commission (2020): Sustainable Corporate Governance. <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance>. Last retrieved: 2021-04-19.

⁴ European Commission (2021): EU Sustainable Finance April package. https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-communication-factsheet_en.pdf. Last retrieved: 2021-04-23.

⁵ EU Commission (2021): Proposal for a directive of the European parliament and of the council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting. https://ec.europa.eu/finance/docs/law/210421-proposal-corporate-sustainability-reporting_en.pdf. Last retrieved 2021-04-23.

⁶ European Commission (2020): Non-financial reporting. https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en. Last retrieved: 2021-04-19.

⁷ European Commission (2020): EU taxonomy on sustainable activities. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en. Last retrieved: 2021-04-19.

In addition to these two important measures within the EU's sustainable finance, there is also:

3. The **Sustainable Finance Disclosure Regulation** (SFDR⁸) that defines disclosure obligations for financial market actors to show how they integrate sustainability risks in their decisions and how they report their strategy, objectives, and impacts accordingly.

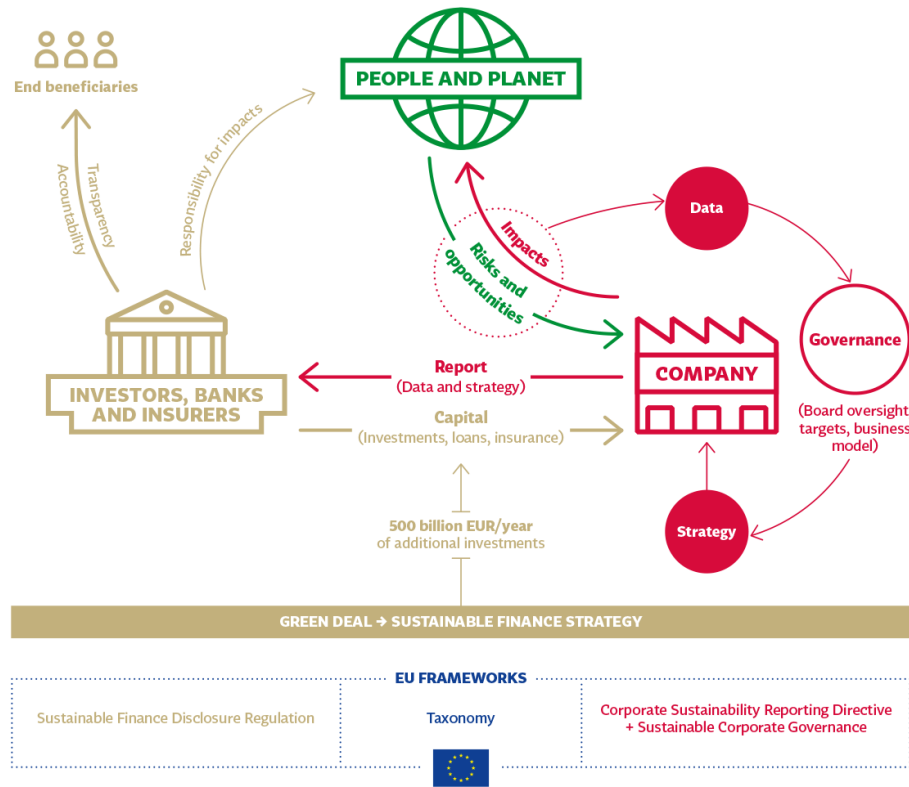


Figure 1: Reporting, strategy and governance framework for sustainable finance⁹.

This article addresses three questions regarding SFDR, EU Taxonomy Regulation, and CSRD:

1. How do these three measures fit together?
2. What needs to be reported and by whom?
3. What are the gaps that the upcoming CSRD will have to close?

⁸ EUR-Lex (2019): 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 (Text with EEA relevance). <https://eur-lex.europa.eu/eli/reg/2019/2088/oj>. Last retrieved: 2021-04-19.

⁹ Own illustration by Frank Bold (2021).

What needs to be reported by whom and what is currently missing

The **SFDR applies to all financial market participants**, primarily institutional investors, including banks and insurers' investment activities. The **proposed CSRD applies to large companies** (>250 employees) **and all listed companies**, including banks and insurers' own activities - they are both preparers and users of sustainability information¹⁰. The **Taxonomy Regulation applies to companies** falling within the scope of the existing Non-Financial Reporting Directive – and the additional companies brought **under the scope of the proposed CSRD**, if approved by the co-legislators – **and to financial participants falling within scope for SFDR** that sell products that promote sustainable characteristics.

The EU taxonomy clarifies what can be labelled sustainable. Separate Commission Delegated Acts specify relevant indicators, covering activities that substantially contribute to one of EU environmental objectives (such as climate mitigation, but also biodiversity or circular economy) and at the same time do not harm other environmental objectives (the “do no significant harm criterion”). Companies will have to report these indicators alongside other sustainability information mandated by the proposed CSRD. The corresponding EU sustainability reporting standards to be developed under the CSRD will fully take into account these indicators and build on the 'substantial contribution' and 'do-no-significant-harm' criteria of the Taxonomy¹¹.

The taxonomy's screening criteria for activities considered to make a substantial contribution to climate change mitigation and climate change adaptation were adopted with the Climate Delegated Act on 21 April 2021 and will apply from 1 January 2022. A report by UNEP FI and the European Banking Federation¹² provides practical understanding of the applicability of the EU Taxonomy to banking products. Furthermore, the UN PRI case studies¹³ share insights from over 40 investment managers and asset owners how to use the taxonomy.

While the Taxonomy Regulation is first to be applied to climate change objectives, the SFDR requires to disclose on the adverse impact of investment decisions on sustainability factors in relation to climate change, other environment-related impacts, and adverse impacts in the field of social and employee matters, human rights, and anti-corruption and anti-bribery matters¹⁴. To clarify what and how to disclose, the European Supervisory Authorities developed draft regulatory technical standards (RTS)¹⁵ covering 16 adverse sustainability indicators.

¹⁰ Read our first article to learn about the review process of the NFRD this year here: <https://germanwatch.org/en/19990>

¹¹ EU Commission (2021): Questions and Answers: Corporate Sustainability Reporting Directive proposal https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_1806. Last retrieved: 2021-04-23.

¹² UNEP FI, EBF (2021): Testing the application of the EU taxonomy to core banking products: High level recommendations. <https://www.unepfi.org/wordpress/wp-content/uploads/2021/01/Testing-the-application-of-the-EU-Taxonomy-to-core-banking-products-Final-v2.pdf>. Last retrieved: 2021-04-19.

¹³ UNPRI (2019): EU Taxonomy alignment case studies. <https://www.unpri.org/policy/eu-sustainable-finance-taxonomy/eu-taxonomy-alignment-case-studies>. Last retrieved: 2021-04-19.

¹⁴ EU 2019/2088: 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. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN>. Last retrieved 2021-04-23.

¹⁵ ESMA (2021): Final Report on draft Regulatory Technical Standards (Table 1 Annex 1). https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf. Last retrieved 2021-04-23.

	Sustainable Finance Disclosure Regulation (SFDR)	Proposal New Corporate Sustainability Reporting Directive (formerly NFRD)	EU Taxonomy Regulation and Climate Delegated Act
Objective	<ul style="list-style-type: none"> enhance greater transparency on the sustainability of financial products 	<ul style="list-style-type: none"> enhance climate and sustainability-related information provided by corporates 	<ul style="list-style-type: none"> classification and technical criteria of environmentally sustainable activities
Scope	<ul style="list-style-type: none"> asset managers, financial advisers and insurance providers in the European Union 	<ul style="list-style-type: none"> large companies (> 250 employees) and all listed companies, except listed micro-enterprises 	<ul style="list-style-type: none"> companies falling within the scope of Non-Financial Reporting Directive (and then CSRD) financial participants falling within scope for SFDR that sell products which promote sustainable characteristics (e.g. ESG or sustainable funds)
Reporting requirements	<ul style="list-style-type: none"> assessment on sustainability risks that could have a negative financial impact and how investments could adversely impact sustainability factors ("double materiality") statement on due diligence of sustainability risks, integration of sustainability factors in the remuneration policies measurement of the adverse sustainability impacts at the entity level as well as product level (disclosure of "Principal Adverse sustainability Impacts" (PAIs)) 	<ul style="list-style-type: none"> building on the double-materiality, principal impacts (in line with due diligence) and principal risks business model, strategy, sustainability opportunities and alignment with 1.5 °C goal targets related to material sustainability factors governance and organisation of sustainability mandatory reporting standards will be developed for key sustainability factors 	<ul style="list-style-type: none"> percentage of turnover, capital expenditures and operational expenditures aligned with the EU taxonomy

Table 1: SFDR, CSRD, EU Taxonomy - an overview¹⁶.

¹⁶ EU Commission (2020): EU's Action Plan on Sustainable Finance – where are we now? https://www.feem.it/m/events_pages/feem-eu-action-plan-status-23-july-2020-13585-.pdf. Last retrieved 2021-04-23.

EUR-Lex (2019): 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 (Text with EEA relevance). <https://eur-lex.europa.eu/eli/reg/2019/2088/oj>. Last retrieved: 2021-04-19.

EUR-Lex (2020): Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN>. Last retrieved: 2021-04-23.

EU Commission (2021): Proposal for a directive of the European parliament and of the council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting. https://ec.europa.eu/finance/docs/law/210421-proposal-corporate-sustainability-reporting_en.pdf. Last retrieved 2021-04-23.

Bloomberg (2021): The relationships between SFDR, NFRD and EU Taxonomy. <https://www.bloomberg.com/professional/blog/the-relationships-between-sfdr-nfrd-and-eu-taxonomy/>. Last retrieved 2021-04-23.

What is missing?

So far, **the current NFRD lacks in clarifying what needs to be reported** by companies on both sustainability-related risks and impacts of their activities and across their supply chains. **Reliable and comparable EU sustainability reporting standards are crucial** to ensure that companies disclose meaningful and comparable information, which is also needed by investors and banks to fulfil their obligations under the SFDR. **Standardisation is needed** to better align these regulations and to improve consistency, comparability, and reliability of sustainability data and thus to reduce companies' administrative burden.

The adoption of EU sustainability reporting standards is one of the key objectives of the new CSRD. Such standards are intended to provide mandatory European generic as well as sector specific indicators on which companies would have to disclose on. While the current CSRD proposal intends to broaden the scope (see Figure 1), it still falls short of targeting medium-sized companies from high-risk sectors that would then have to disclose on these standards- in contradiction to the EU Parliament's clear call for the integration of all companies from high-risk sectors¹⁷. This is needed to allow investors and relevant stakeholders to receive sustainability information not only from large companies but also from medium-sized companies with high negative impacts, such as in the energy and mining sectors or agri-business.

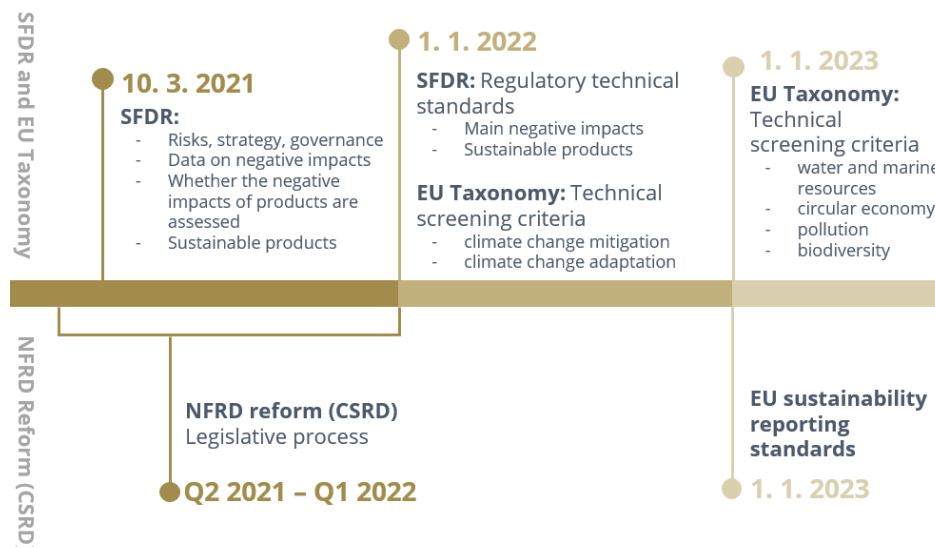


Figure 2: Visual timeline of EU sustainability reporting standards within Sustainable Finance Framework¹⁸.

¹⁷ Public statement "EU Commission presents proposal for new CSRD (2021)": <https://www.germanwatch.org/en/20154>. Last retrieved: 2021-0506.

¹⁸ Alliance for Corporate Transparency (2021): <https://www.allianceforcorporatetransparency.org/assets/2104-timeline-nfrd-sfdr-taxonomy-standards.png>. Last retrieved: 2021-04-19.

CSRD falls short on using scenario analyses for forward-looking reporting standards

Integrated and forward-looking reporting is one of the five main priorities of the final recommendations by the German Sustainable Finance Committee¹⁹. However, the current **CSRD proposal falls short on clarifying how forward-looking reporting standards could be developed**. The Committee sees one solution to this in the **use of scenario analysis**. Based on the analysis of scenarios (e.g. Greenhouse gas neutrality by 2050 and a stress test scenario based on a 1.5°C pathway,) companies need to report on their strategies, actions and targets to manage the risks. Forward-looking EU sustainable reporting standards need to reflect this. For forward-looking climate-related opportunities and risks, the Committee also recommends to adopt the recommendations of the Task Force on Climate-related Financial Disclosure, incl. the use of scenario analyses.

Why do the SFDR and the Taxonomy Regulation need the EU sustainability reporting standards under the CSRD?

The SFDR and the Taxonomy Regulation rely on the EU sustainability reporting standards to fill the gaps in clarifying what and how specific reporting requirements can be fulfilled in a consistent, comparable and reliable way under these regulations. For this, the EU sustainability reporting standards need to give guidance for indicators, quality criteria and methodologies in four critical areas:

1. **To fulfil the SFDR: Clarification on minimum criteria for disclosure of companies' decarbonisation objectives and financial risks** related to climate change vis-a-vis the goals of the Paris Agreement.

The SFDR requires these to be considered by investors, but it does not specify how this should be assessed and which quality criteria to disclose. The EU sustainability reporting standards should specify, e.g. on how and what to disclose in terms of timeline and intermediary objectives towards decarbonisation, use of scenarios and alignment with a science-based methodology.

2. **To fulfil the SFDR: Specification on methodologies for calculating investee companies' climate impacts**, other environment-related impacts, and adverse impacts in the field of social and employee matters, human rights, and anti-corruption and anti-bribery matters. Scenario analysis as a tool to assess these impacts needs to be anchored.

So far, the draft regulatory technical standards (RTS) developed for this, specify only the formula for linking impact indicators to the value of their investments, e.g. with respect to their carbon footprint of their investments, but not for the concrete calculation of the companies' impact indicators. Currently, many companies that claim to be reporting scope 3 greenhouse gas emissions do so only in a 'limited' way, that is, excluding the vast majority of emissions from the presented total.

3. **To fulfil the SFDR and EU Taxonomy Regulation: Clarification on what should be disclosed as a minimum** to ensure that sustainable activities and financial products are not connected to severe adverse impacts across the value chains - a condition required by both the SFDR and Taxonomy Regulation.

¹⁹ Sustainable Finance Committee to the German federal government (2021-03-29): Shifting the Trillions A sustainable financial system for the great transformation. Last retrieved: 2021-04-29.

The SFDR and Taxonomy Regulation merely specify that the due diligence processes should be aligned with international standards, such as the OECD Guidelines, but do not clarify what as a minimum needs to be disclosed to give an indication of the quality of a company's due diligence.

4. **To fulfil the SFDR and a future social Taxonomy Delegated Act: Specification on a basic set of social indicators** and quality criteria addressing relevance, reliability, and measurability that both standardised and entity-specific indicators must meet. The SFDR standards outline several additional indicators of adverse human rights impact for companies to choose from, which do not meet such basic criteria, and whose blind application would lead to meaningless disclosures and administrative burden.

Such key performance indicators, which the EU sustainability reporting standards must put into context, include whether a company has a policy against trafficking, number of incidents of severe human rights impacts, and percentage of operations and suppliers at risks of child and forced labour.

What are the risks and opportunities for businesses in the CSRD proposal, including EU sustainability reporting standards?

The reform of the NFRD and a development of comparable EU sustainability reporting standards are a **necessity** towards an effective sustainable finance framework:

- **Sustainable finance needs:** Investors, banks and insurers need data from companies to meet their own disclosure requirements, but also - more importantly - to be able to consider the impacts, financial risks and opportunities linked to their investment decisions. In the absence of a legislative mandate and clarification of methodologies, the data available to financiers will continue to be patchy and unreliable (see the research results on 1000 companies here²⁰).
- **Access to finance and risks to companies' competitiveness:** The NFRD currently applies only to listed companies with more than 500 employees. This leaves a majority of large European companies (around 35 thousand of them²¹), as well as many companies from high-risk sectors, out of the scope. The extension of scope and the development of EU sustainability reporting standards under the new CSRD sheds light on these companies' efforts, as well. Increased transparency and greater disclosure efforts might have positive or negative influence on conditions for access to loans and investments for transformational activities, which in turn can drive market developments. The ability to collect and present relevant data to show a company's resilience might become a major competitive advantage.
- **Closing the data gap:** Investors and banks that have already started to realign their strategies around financing the economic transition have also complained about the need for data from SMEs, as they form most of their clients. Without a legislative mandate and clear standards it will be very difficult for SMEs to report such data.

Current reporting landscape as a burden for small and mid-sized enterprises:

The current framework of voluntary reporting standards, diverse requirements of individual investors, sustainability rating agencies and buyer companies, and conflicting recommendations of consultants, creates excessive administrative burden for companies. As found by the EU Project Task Force on EU

²⁰ Alliance for Corporate Transparency (2020): Landmark research on 1000 European companies shows troubling poor quality of reporting on sustainability issues. <https://www.allianceforcorporatetransparency.org/news/landmark-research.html>. Last retrieved: 2021-04-19.

²¹ eurostat (2021): Number of enterprises in the non-financial business economy by size class of employment. <https://ec.europa.eu/eurostat/databrowser/view/tin00145/default/table?lang=en>. Last retrieved: 2021-04-19.

standards²², the number of KPIs suggested by existing reporting initiatives exceeds 5000. Listed companies face a huge amount of requests and forms to have their sustainability performance rated. Various methodologies lead to different outcomes, rating some companies simultaneously the worst by various benchmarks²³. Dubbed ‘an alphabet soup’, this context makes it difficult for companies to decide which data to focus on. It also discourages companies’ management to take sustainability data seriously in a business context. This is even a bigger problem for smaller companies, some of which need to start their sustainability reporting from scratch. A legislative mandate and clear reporting standards are therefore needed to guide them towards meaningful and effective reporting.

Conclusion

The EU sustainability reporting standards under development are of critical importance to bridge gaps among the different measures within the EU sustainable finance framework. It needs to be secured that 1) data is comparable and meaningful, 2) it alleviates companies’ administrative burden, and 3) it ensures that smaller businesses are not shut out from access to sustainable finance. In the absence of clear indicators and clarifications, companies’ strategies and investors’ decisions will continue to be based on a high degree of uncertainty on both adverse impacts and financial risks.

In this article, we highlight gaps that need to be addressed, in order to improve the quality of company reporting and ensure it is useful for investors, which in turn will enable companies to more easily access sustainable capital and drive capital flows to support climate transition overall.

Summing up, the proposed CSRD and the EU sustainability reporting standards need improvement and adjustment in the following areas:

- a broader scope, covering a wider group of companies
- a clear, simplified set of metrics and indicators
- underlying methodologies for corporate reporting to match those provided for investor disclosure
- details on how to assess whether a company’s targets, timeline and KPIs are aligned with Paris and SDG goals, taking into account scenario analyses
- an assessment of minimum social standards in relation to the company’s supply chain
- specification of meaningful disclosures of adverse human rights and environmental impacts

²² EFRAG (2020): Progress report published for project on preparatory work for the elaboration of possible EU non-financial reporting standards. <https://www.efrag.org/News/Project-449/Progress-report-published-for-project-on-preparatory-work-for-the-elaboration-of-possible-EU-non-financial-reporting-standards?AspxAutoDetectCookieSupport=1>. Last retrieved: 2021-04-19.

²³ Mackintosh, James.WSJ (2018): Is Tesla or Exxon More Sustainable? It Depends Whom You Ask. <https://www.wsj.com/articles/is-tesla-or-exxon-more-sustainable-it-depends-whom-you-ask-1537199931>. Last retrieved: 2021-04-19.

This article is part of our series "**Full Disclosure: Monthly Briefing on EU Corporate Transparency Regulation**", in which we aim to shed light on the need for and benefits of forward-looking reporting requirements in a changing EU regulatory environment. The series includes to date:

- **Reform of the EU Non-financial Reporting Directive: A Push Towards Future-proof Reporting Obligations** (March 2021 Issue): www.germanwatch.org/en/19990
- **What needs to be reported on sustainability-related governance?** (April 2021 Issue): www.germanwatch.org/en/20081

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You can download this article here: www.germanwatch.org/en/20152

2021/05/06

Order Number: 21-2-05e

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