

**Faculty of Law, Economics and
Finance of the University of
Luxembourg**

Regulatory Update – The European legal initiatives in Sustainable and Inclusive Finance

Prof. Dr. Dirk A. Zetsche, LL.M. (Toronto)
Roberta Consiglio, MSc (Bocconi)
ADA Chair in Financial Law (Inclusive Finance)


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- I. Introduction
- II. L2 Works on Environmental Taxonomy
- III. L2 Works on SFDR
- IV. The European SF Strategy 2021
- V. Conclusions

I. Introduction

I. The European SF Strategy

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2018 EU SF Action Plan

		L1		L2	
<i>EU Taxonomy</i>		Environmental Taxonomy	Q&A	✓	SFDR/Taxonomy RTS 
					TSC/KPIs 
		Social Taxonomy			More/Amended RTS 
<i>Disclosures</i>		SFDR	Q&A	✓	SFDR/Taxonomy RTS ?
		CSRD/NFRD	Q&A		NA 
<i>Operations</i>		Fiduciary Duties			L2 on MiFID 2 ✓
					L2 on CIS 
<i>Tools</i>		EU climate Benchmarks	Q&A	✓	L2 on ESG explanation ✓
					L2 on ESG content ✓
					L2 on min standards ✓
		EU Green Bonds Standard			NA ?

II. L2 of Environmental Taxonomy (July 201)

Delegated and implementing acts

- Definition of Technical Screening Criteria (TSC) for each environmental objective (EO)
- TSC only available for climate change adaptation and mitigation

EU Taxonomy Climate
Delegated Act
(4 Jun 2021)



C(2021) 4987 final
(6 Jul 2021):
Into force 1 Jan 2022

EU Taxonomy Climate Delegated Act (4 Jun 2021)

- Establishes list of ES activities
- TSC for two EOs:
 - Arts 1 to 3 + Annexes
 - Climate change mitigation + DNSH (art 1)
 - Climate change adaptation + DNSH (art 2)
 - Entry into force (art 3)

Example: Annex 1 - 3.6. Manufacture of other low carbon technologies

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<i>Technical screening criteria</i>	Do no significant harm ('DNSH')	
Substantial contribution to climate change mitigation	(2) Climate change adaptation	The activity complies with the criteria set out in Appendix A to this Annex.
	(3) Sustainable use and protection of water and marine resources	The activity complies with the criteria set out in Appendix B to this Annex.
	(4) Transition to a circular economy	<p>The activity assesses the availability of and, where feasible, adopts techniques that support:</p> <ul style="list-style-type: none"> (a) reuse and use of secondary raw materials and reused components in products manufactured; (b) design for high durability, recyclability, easy disassembly and adaptability of products manufactured; (c) waste management that prioritises recycling over disposal, in the manufacturing process; (d) information on and traceability of substances of concern throughout the life cycle of the manufactured products.
	(5) Pollution prevention and	The activity complies with the criteria set out in Appendix C to this Annex.
	(6) Protection and restoration of biodiversity and ecosystems	The activity complies with the criteria set out in Appendix D to this Annex.

C(2021) 4987 final + Annexes

- Refers to art. 8 TR:
 - Scope: undertakings under NFRD
 - To disclose how and to what extent their activities are taxonomy aligned
- Translates technical screening criteria into KPIs
 - proportion of their turnover
 - capital expenditure (CapEx); and
 - operating expenditure (OpEx) related to environmentally sustainable activities.

Different KPIs for:

- Non-financial undertakings
 - breakdown of the KPIs based on the economic activity pursued
 - Example: $\frac{\text{[turnover from products or services that are taxonomy-aligned]}}{\text{[turnover from all products and services]}}$
- Asset managers
 - each EO and aggregated environmentally sustainable economic activities;
 - a subset of transitional and enabling economic activities; and
 - type of investment (instrument)
 - Example: $\frac{\text{[taxonomy-aligned investments under management]}}{\text{[all covered assets under management]}}$
 - Covered assets: all AuM except for sovereign exposures.
- Credit institutions
 - GAR (Green Asset Ratio)
 - KPIs for off-balance sheet assets; and
 - KPI for commissions and fees related to other activities than financing.
 - Example: $\frac{\text{[existing on-balance sheet assets financing taxonomy-aligned economic activities]}}{\text{[total on-balance sheet covered assets]}}$

Other KPIs for:

- Investment firms (other than asset managers)
- Insurers and reinsurers
- Sovereign and central bank exposures
- Derivatives

Questions answered

- Sovereign exposures in KPIs of financial undertakings
- Interactions with Climate Delegated Act
- Interactions with NFRD and CSRD
- Transitional and enabling activities
- Disclosure of exposures to companies that are not under the scope
 - E.g. SMEs, non-EU companies

III. L2 works on SFDR

L2 Works on SFDR

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Q&A	EBA - BSG	EIOPA - IRSG	EIOPA - OPSG	ESMA - SMSG
1. Single rulebook or separate RTS?	FOR	FOR	FOR	FOR
2. KPI metrics / same approach	FOR but data?	FOR but what about transitional activities?	FOR , issues with T/O in precontractual disclosure	AGAINST , no same approach for all issuers
3. Pros/Cons of OpEx in the KPI	FOR but CSRD?!	AGAINST better Capex	FOR	FOR but questionable
4. Derivatives and CFDs?	FOR but look-through approach	AGAINST for valuation issues	AGAINST	FOR
5. Equities and Debt Instruments clear ?	FOR but list of examples	FOR	FOR	FOR but further explanation needed (e.g. equity)
6. Sovereign bonds in the denominator of KPI?	FOR	FOR	AGAINST	AGAINST

L2 Works on SFDR

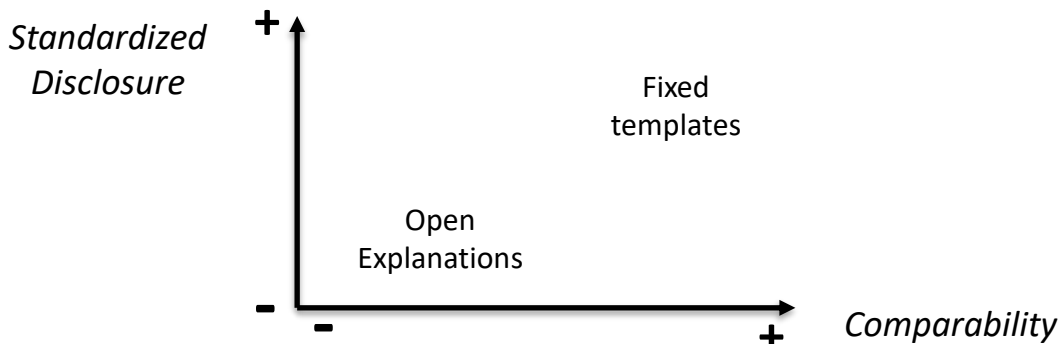
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Q&A	EBA - BSG	EIOPA - IRSG	EIOPA - OPSG	ESMA - SMSG
7. Assessment by third parties?	AGAINST better upstream	FOR but no guarantee of better disclosure and unnecessary for now, better upstream	FOR but no mandatory	FOR but advisory nature rather than compliance
8. Pre-contractual mirroring periodic disclosure?	NA	FOR	FOR	NA
9. Amended pre-contractual and periodic templates	AGAINST min taxonomy investments	AGAINST , consumer testing proposed, also uncertainty from min taxonomy investments	AGAINST	AGAINST , complexity due to for instance confusing terminology
10. Same templates for Art. 8 and 9 SFDR?	AGAINST better to have different templates	FOR	FOR	AGAINST
11. Indication of green taxonomy alignment for SSI?	AGAINST	AGAINST	AGAINST	FOR but many changes suggested
12. Costs associated with the policy options?	NA	Underestimation, examples on real fin products missing	Examples on real fin products needed	Remarks provided

SFDR RTS provides a revision of templates and clarifies:

1. Why 3 versions?
2. Main features of the Oct version
 - Structure
 - Sub-categories of Arts 8 and 9
3. Policy issues and regulatory approaches
 - Issues solved
 - Remaining issues (not solved)



JC 2021 03
(2 Feb 2021)



JC 2021 22
(15 Mar 2021)



JC 2021 50
(22 Oct 2021)

SFDR L2: Why 3 version?

- Disclosure for taxonomy-related products in Mar/Oct versions
- Oct 'single rulebook': feb 21 + march 21 elements + new
- Oct version clarifies link between SFDR and TR
- SSI taken into account: adoption of social taxonomy in the future

SFDR L2: Why 3 version?

- One more subcategory of precontractual disclosures (next slides)
- Explanation for DNSH/PAI on product-level required (not in Mar)
- Minimum share of socially sustainable investments included

SFDR L2: Why 3 version?

1. Why 3 versions?

Art. 8 Financial Products
1) E/S characteristics promotion <i>only</i>
2) <i>Mix</i> of E/S promotion and sustainable investment

Art. 9 Financial Products
Sustainable Investments

Art. 8

Art. 9

- Overall 5 categories of investments
 - Non-Sustainable
 - Promotion of ESG characteristics
 - ESI (taxonomy aligned)
 - SSI (future social taxonomy aligned)
 - Sustainable but not taxonomy aligned (eg Paris aligned)

SFDR L2: Why 3 version? – Art. 8 / L2 Annex II

Feb/Mar/Oct 21

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Does this financial product have a sustainable investment objective? *[tick and fill in as relevant, the percentage figure represents the minimum commitment to sustainable investments]*



Yes



No



It will make a minimum of
**sustainable investments with an
environmental objective:** ____%



in economic activities that
qualify as environmentally
sustainable under the EU
Taxonomy



in economic activities that do
not qualify as environmentally
sustainable under the EU
Taxonomy



It will make a minimum of
**sustainable investments with a
social objective:** ____%



It promotes **Environmental/Social (E/S)**
characteristics and while it does not have as
its objective a sustainable investment, it will
have a minimum proportion of ____% of
sustainable investments



with an environmental objective in economic
activities that qualify as environmentally
sustainable under the EU Taxonomy



with an environmental objective in
economic activities that do not qualify as
environmentally sustainable under the EU
Taxonomy



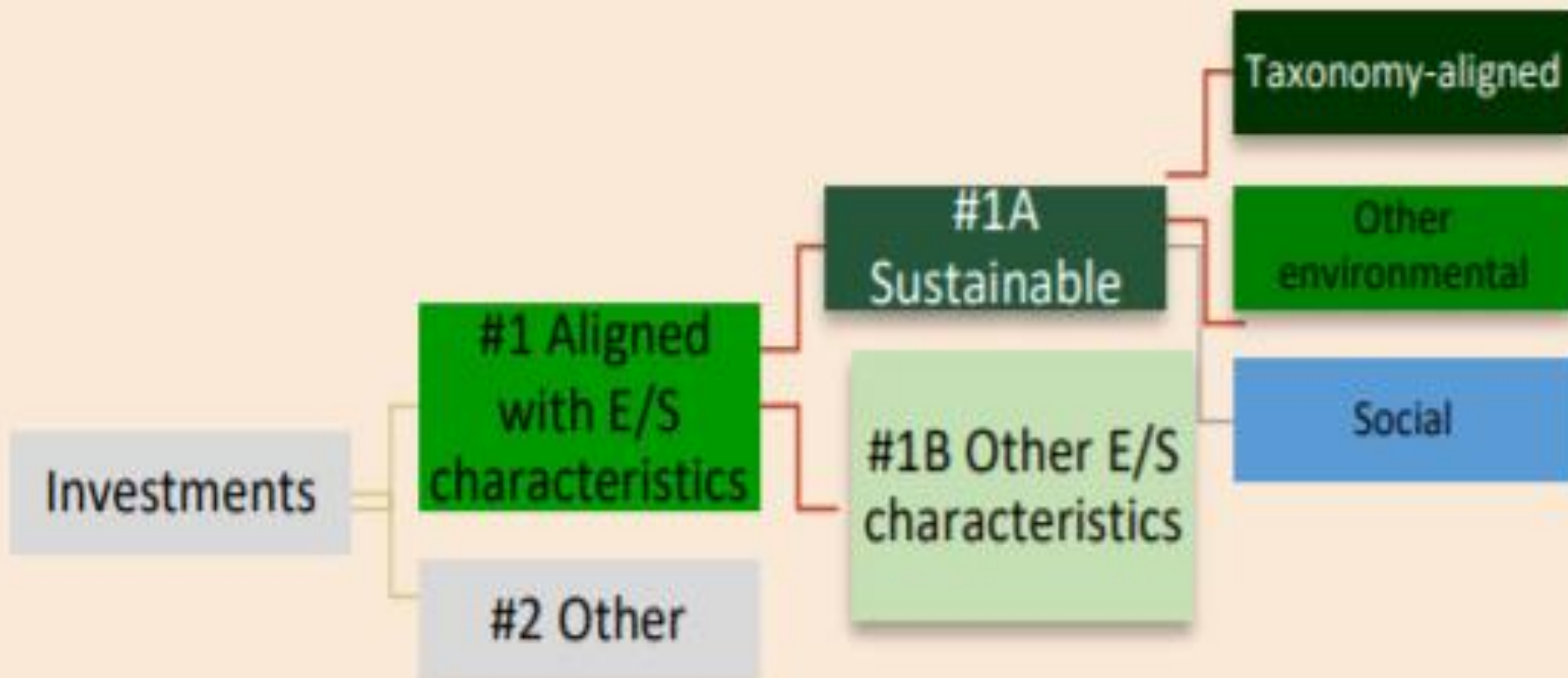
with a social objective



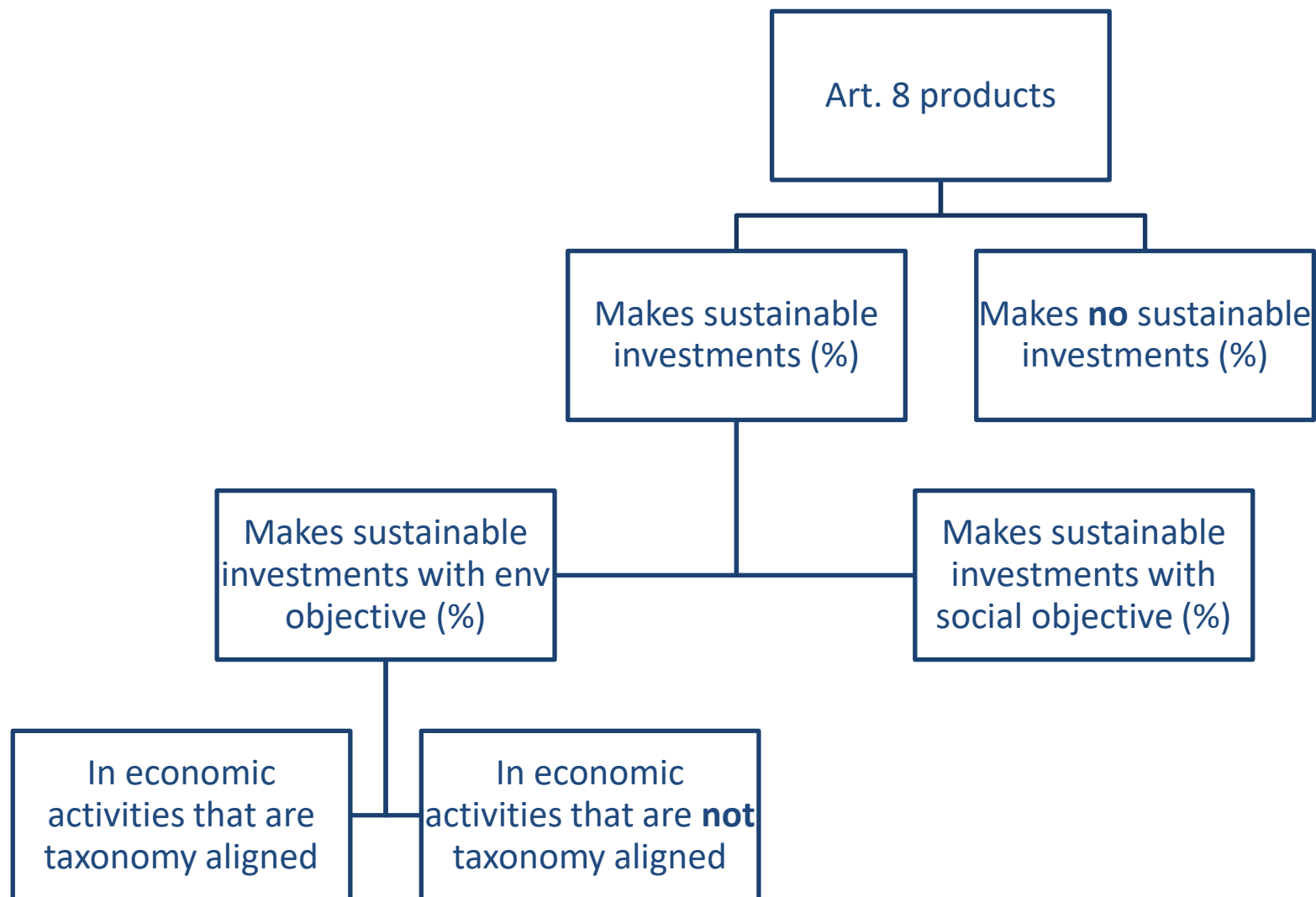
It promotes E/S characteristics, but **will not
make any sustainable investments**

SFDR L2: Why 3 version? - Categories Feb/Mar/Oct 21

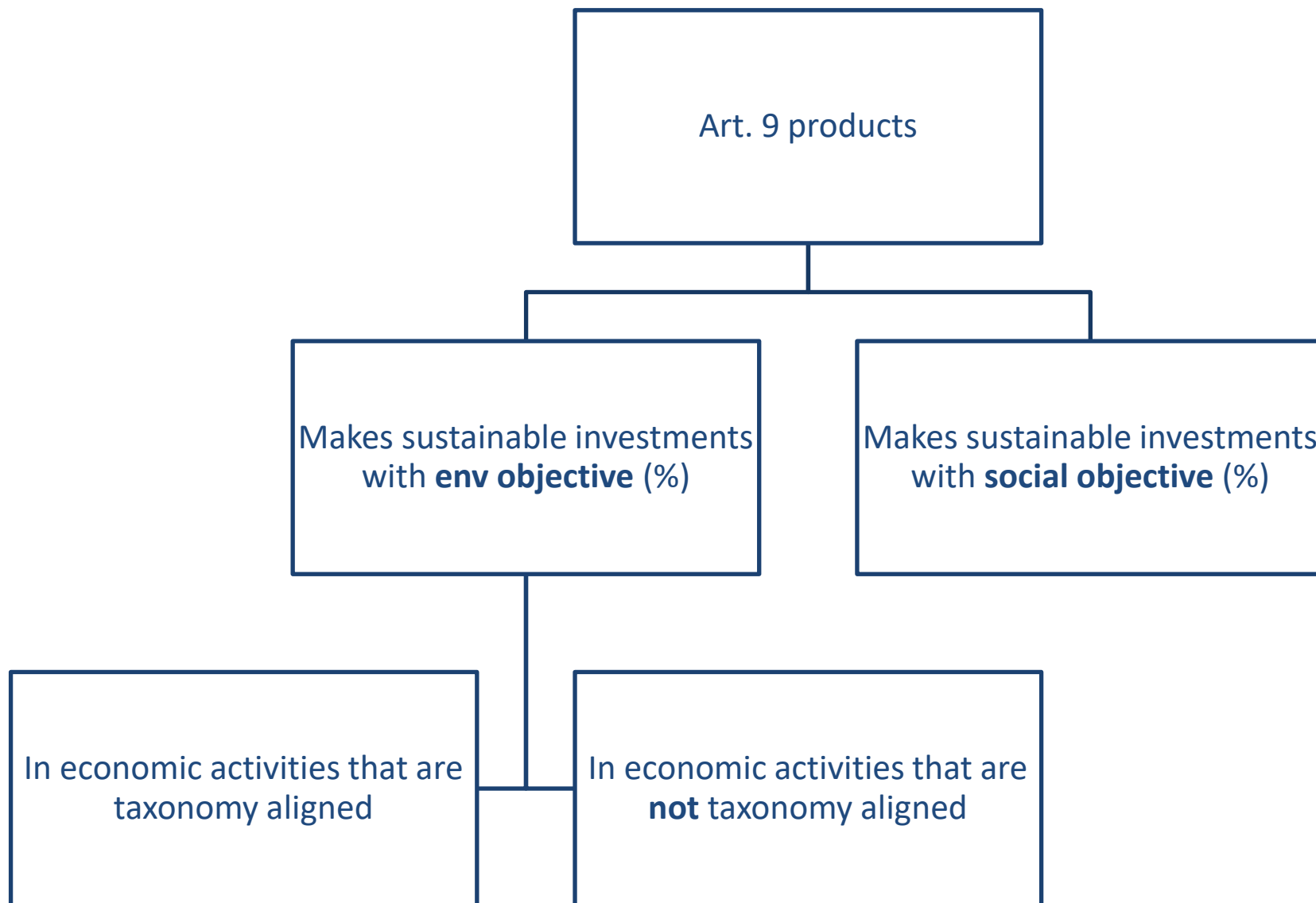
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L2 Works on SFDR – Art. 8 Oct version



L2 Works on SFDR – Art. 9 Oct version





Issue 1: Lack of env objectives disclosure in old versions

- Art 5(a) TR not fulfilled if info on environmental objectives (EO) not disclosed
- JC 2021 50 treats art 8 and 9 products with EO as subcategories (*Art 13, 20 L2*).

Issue 2: Uncertainty on how to deal with short positions

- SFDR does not clarify how to treat short positions
- JC 2021 50: application of EU Short Selling Regulation for taxonomy alignment (vs 'naked' shorts) (*Art 16b L2*).

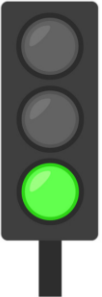
Issue 3: Uncertainty on SFDR Principal Adverse Impacts disclosures

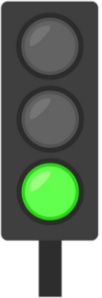
- SFDR does not clarify how financial products consider PAI
- JC 2021 50: “clear and reasoned explanation” on PAI in pre-contractual disclosures (*Art 14a and 22 L2*).

Issue 4: Standardization in pre-contractual and periodic disclosure info

Options:

- Integration of TR disclosures with SFDR disclosures in one template
 - Separate mandatory template for Taxonomy disclosures
 - No template for Taxonomy disclosures
- *One template for SFDR and Taxonomy disclosures (Art 16a, 16b, 25, 61a, 67a L2).*

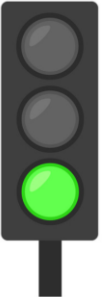




Issue 5: KPI disclosure

- KPIs based on revenue, or payments from investors
 - Weighted Average Turn/CapEx/OpEx-based KPI of the taxonomy-aligned investee companies' activities
 - Granular disclosure of each activity
- *Weighted Average approach preferred but no detailed methodology indicated in the RTS*

(see Impact assessment p. 57 RTS Oct and art. 16b L2)



Issue 5: KPI disclosure (cont'd)

How to calculate taxonomy-alignment based on weighted average? Calculate %.

[market value of all taxonomy-aligned investments of the financial product]

[market value of all investments of the financial product]

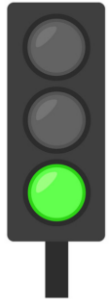
- For pre-contractual disclosure (art. 16a L2)
 - Turnover default KPI for non-fin companies
 - CapEx or OpEx for fin market participants
- For periodic disclosure: all 3 KPIs should be disclosed (art. 67a L2)

Issue 6: Choice of KPI

Options:

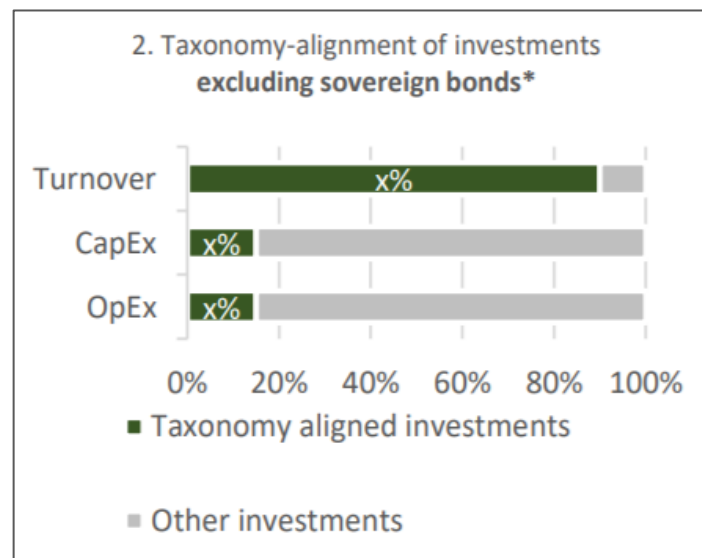
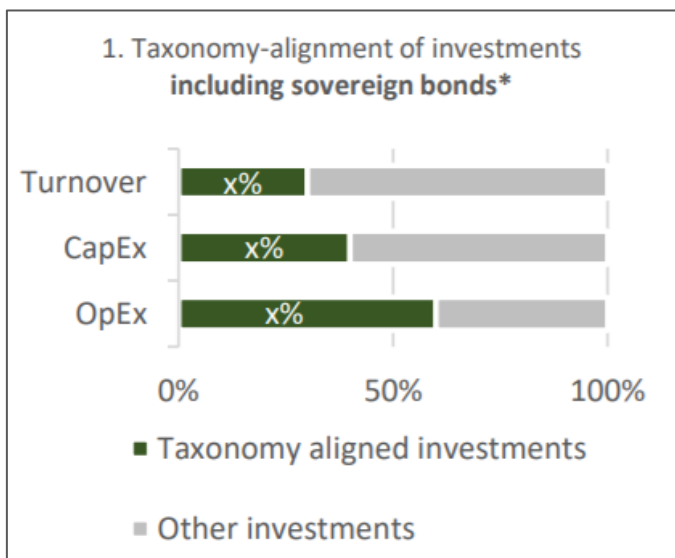
- Flexible choice of KPI for each activity/investment
- Choice of a single KPI per product
- Mandatory KPI per asset type and investee company

➤ *Choice of a single KPI per product (Art. 16a L2)*



Issue 7: Sovereign exposures ⇔ comparability

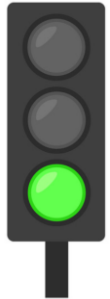
- Difficulty to assess taxonomy-alignment of sovereign exposures (and other non-Env Taxonomy aligned actors): lack of data, mixed activity
- *JC 2021 50: two different KPIs in parallel (Art. 67a L2); sovereign exposures reduce taxonomy alignment of overall portfolio*



Issue 8: Disclosure on compliance with TR ?

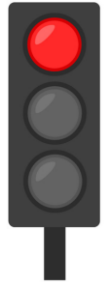
Options:

- No statement of compliance with Art 3 TR
 - Voluntary disclosure assured by an auditor or other
 - Mandatory disclosure assured by an auditor or verified by a third party
 - Granular disclosure of each activity financed by financial market participant
- *Voluntary indication of compliance with Article 3 TR assured by an auditor or verified by a third party (Art. 25 L2)*



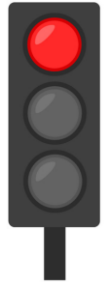
Issue 9: Lack of data

- ESG data availability limited, but crucial to assess KPIs
- ESAs refer in policy documents to third party providers and sectorial estimates, but refrain from providing legal certainty in L2
- Risk of misrepresentation of SSI; no taxonomy so far
 - Distinction ESI and SSI; requirements reduced for SSIs
- Lack of commonly agreed metrics and indicators
 - Burdensome reporting
 - Potentially high costs due to oligopoly of ESG data providers
 - Sectorial estimates: on which basis?



Issue 10: Complexity

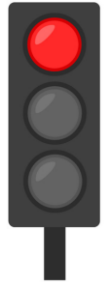
- TR empowers the ESAs (by amending SFDR) to develop further RTS
 - JC 2021 22 (Mar 21) amends Feb 21 to reduce complexity & duplication
 - JC 2021 50 (Oct 21) further amends JC 2021 22 (Mar 21)
-
- Complexity? (1) dark green (2) light green (3) no-taxonomy aligned
 - Duplication of precontractual and periodic disclosures (Arts 8 and 9)
 - Duplication SFDR L2 DNSH rules + TR Technical Screening Criteria
 - Parts of the Annexes of Feb release remain in force (eg. Annex I on PAIs)



Issue 11: Lack of commonly agreed social objectives

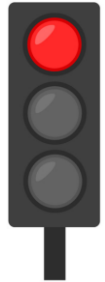
- In pre-contractual disclosures
 - Define % of sustainable investment
 - Description (objectives, indicators, DNSH)
 - Asset allocation

- While EOs are defined in the TR, Social Taxonomy still work in progress
 - Risk to collect not standardized data, less useful and difficult to analyze
 - Burdensome reporting
 - Social objectives as stepchild of EU financial law?



Issue 12: Lack of commonly agreed sustainability indicators

- SFDR empowers ESA to define sustainability indicators
 - SFDR uses Sis 6x, TR refers to definition of SIs in Art. 19(1)e TR
- SIs to measure the attainment of the E/S characteristics / investments
 - Arts 14-59 (pre-contractual art 8 products)
 - Arts 21-65 (pre-contractual art 9 products)
 - Art 71 historical comparison for periodic reports
- Sustainability indicators themselves not defined, nor listed
- Comparability within same organization (periodic reports) to be ensured
- How to ensure comparability across different organization and products?
- Sustainability indicator vs sustainability factor?







Issue 13: Uncertainty re adherence to international standards

- Description of adherence to international standards required
- Different levels of detail in SFDR 2
 - Art 9 (entity level)
 - Arts 14-59 (pre-contractual art 8 products)
 - Arts 21-65 (pre-contractual art 9 products)
 - Art 71 historical comparisons for periodic reports
- Adverse impact indicators to be used
 - Uncertainty on which int standards and codes to take into account
 - Risk to collect not standardized data, less useful and difficult to analyze
 - Make use of PAI list in Annex I of Feb release?



IV. The European SF Strategy 2021

2021 EU SF Strategy

<i>Financing the transition</i> 	1. Framework for transition activities
<i>Inclusiveness</i> 	2. Improve inclusiveness of SF
<i>Fin. Sector Resilience</i> 	3. Framework for transition activities 4. Grow contribution of fin sector 5. Ensure integrity of fin system
<i>Fostering global ambition</i> 	6. Global SF initiatives and standards

Financing the transition



Actions needed

1. Framework for transition activities

- Extension of taxonomy to transition activities + related legislation
- New climate delegated acts to cover more sectors and env goals
- Consider a general framework for labels for financial instruments

Inclusiveness



Actions needed

2. *Improve inclusiveness of SF*

- Empower retail investors and SMEs to access SF options
- Leverage data through digital technologies
- Identify insurance protection gaps
- Publish report on social taxonomy

Fin. Sector Resilience



Actions needed

3. *Address sustainability risks*

- EFRAG, ESMA and IASB to work on new financial reporting standards
- Ensure ESG risks are captured in ratings
- Propose amendments in CRR/CRD/Solvency II Directive

4. *Grow contribution of fin sector to SF*

- Improve disclosure on sustainability targets and transition planning
- Review the fiduciary duties of pension funds
- Improve ratings reliability

Fin. Sector Resilience



Actions needed

5. *Ensure integrity of fin system*

- Address greenwashing
- Foster cooperation among EU public institutions
- Foster cooperation within the financial system

Fostering global ambition



Actions needed

6. *Global SF initiatives and standards*

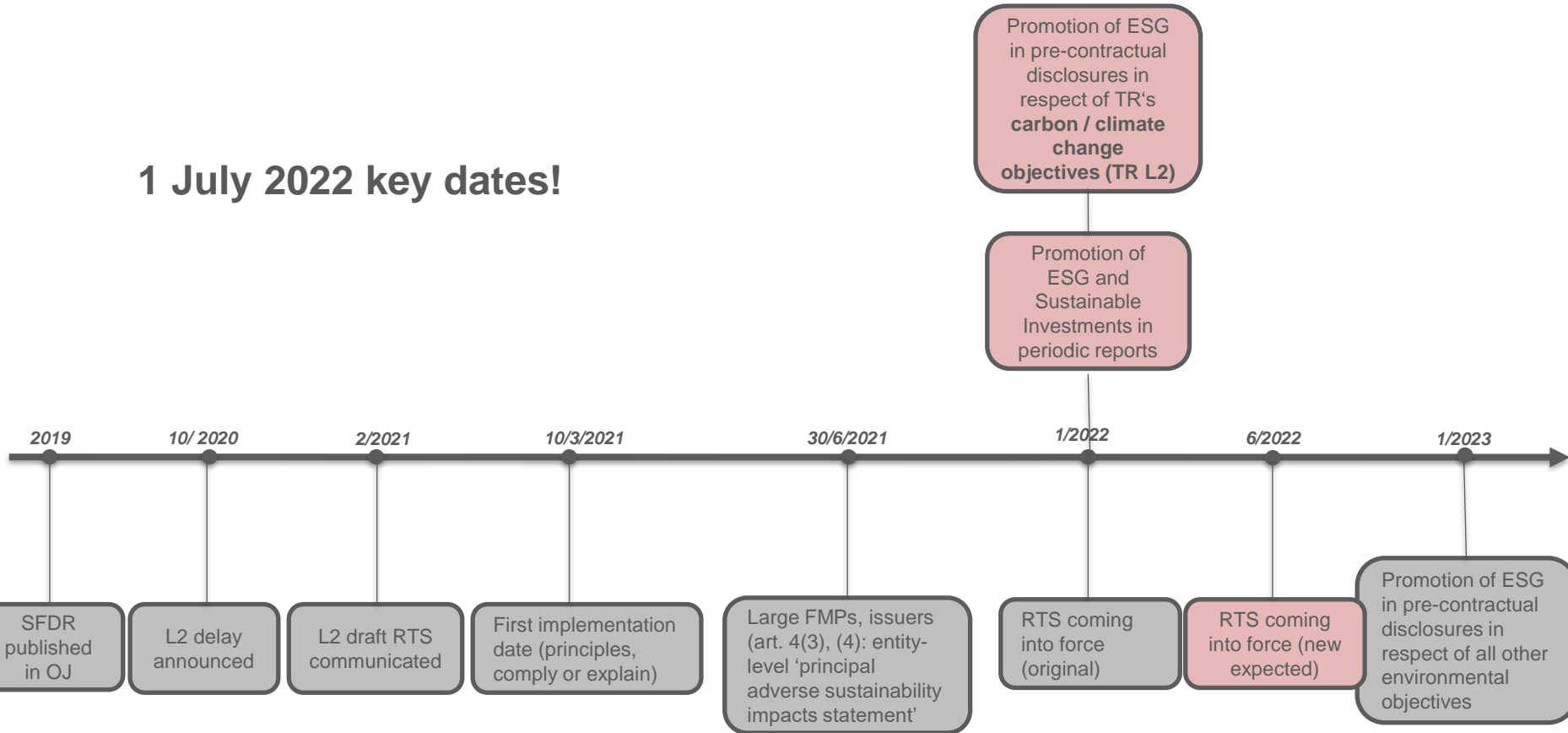
- *Seek international consensus on crucial matters*
- *Possible expansion of IPSF*
- *Support low- and middle-income countries*

V. Conclusions

Coming into force

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1 July 2022 key dates!



The European SF Strategy – an ambitious project in the making ...

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2018 EU SF Action Plan

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<i>Operations</i>		Fiduciary Duties			L2 on MiFID 2 ✓
					L2 on CIS 
<i>Tools</i>		EU climate Benchmarks	Q&A	✓	L2 on ESG explanation ✓
					L2 on ESG content ✓
					L2 on min standards ✓
		EU Green Bonds Standard			NA ?

Thank you!



Dirk A. Zetsche, Linn Anker-Sørensen,
Regulating Sustainable Finance in the Dark,
EBOR 2021.



Prof. Dr. Dirk Zetsche, LL.M.
ADA Chair in Financial Law / Inclusive Finance
Coordinator, Centre for Sustainable Governance & Markets
Faculty of Law, Economics & Finance
University of Luxembourg
Dirk.Zetsche@uni.lu

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Questions – Public consultation

- | |
|---|
| 1. Do you have any views regarding the ESAs' proposed approach to amend the existing SFDR RTS instead of drafting a new set of draft RTS? |
| 2. Do you have any views on the KPI for the disclosure of the extent to which investments are aligned with the taxonomy, which is based on the share of the taxonomy-aligned turnover, capital expenditure or operational expenditure of all underlying non-financial investee companies? Do you agree with that the same approach should apply to all investments made by a given financial product? |
| 3. Do you have any views on the benefits and drawbacks of including specifically operational expenditure of underlying non-financial investee companies as one of the possible ways to calculate the KPI referred to in question 2? |
| 4. The proposed KPI includes equity and debt instruments issued by financial and nonfinancial undertakings and real estate assets, do you agree that this could also be extended to derivatives such as contracts for differences? |
| 5. Is the use of “equities” and “debt instruments” sufficiently clear to capture relevant instruments issued by investee companies? If not, how could that be clarified? Are any specific valuation criteria necessary to ensure that the disclosures are comparable? |
| 6. Do you have any views about including all investments, including sovereign bonds and other assets that cannot be assessed for taxonomy-alignment, of the financial product in the denominator for the KPI? |

Questions - Public consultation

7. Do you have any views on the statement of taxonomy compliance of the activities the financial product invests in and whether those statements should be subject to assessment by external or third parties?

8. Do you have any views on the proposed periodic disclosures which mirror the proposals for pre-contractual amendments?

9. Do you have any views on the amended pre-contractual and periodic templates?

10. The draft RTS propose unified pre-contractual and periodic templates applicable to all Article 8 and 9 SFDR products (including Article 5 and 6 TR products which are a sub-set of Article 8 and 9 SFDR products). Do you believe it would be preferable to have separate precontractual and periodic templates for Article 5-6 TR products, instead of using the same template for all Article 8-9 SFDR products?

11. The draft RTS propose in the amended templates to identify whether products making sustainable investments do so according to the EU taxonomy. While this is done to clearly indicate whether Article 5 and 6 TR products (that make sustainable investments with environmental objectives) use the taxonomy, arguably this would have the effect of requiring Article 8 and 9 SFDR products making sustainable investments with social objectives to indicate that too. Do you agree with this proposal?

12. Do you have any views regarding the preliminary impact assessments? Can you provide more granular examples of costs associated with the policy options?