# Recent developments on Sustainable Finance
## EU regulatory agenda intensifies amid high-level global ambition

**This marketing communication is for professional investors and qualified clients/ sophisticated investors. Investors should read the legal documents prior to investing.**

### Introduction

Sustainable finance and ESG investing have become an ever-increasing priority for both investors and regulators. Heightened by the need to align with climate goals and increasing sustainability commitments, as well as finance the green transition through the COVID-19 recovery, sustainable finance remains a top priority for Europe. Likewise, global initiatives have also intensified their workstreams, particularly around the development of global sustainability reporting standards.

This Article outlines the key regulatory developments in the EU and at international level which are driving the sustainable finance landscape currently and in the near to medium term.

**Firms should prepare for the implementation of several key disclosure, due diligence, and classification frameworks, as well as anticipate the upcoming initiatives on the horizon.**

#### Disclosure, due diligence and distribution

The EU's Sustainable Finance Disclosure Regulation (SFDR) went live in March 2021 but this was just the beginning of the process, as EU policymakers continue to develop the framework and associated legislation.

The EU's Sustainable Finance Disclosure Regulation aims to address greenwashing by introducing transparency requirements across financial market participants and products. The SFDR comprises three broad pillars:

**Sustainability risk integration**
Firms are required to set out, on their websites, information about how they integrate sustainability risks into their investment decision making and how such policies are reflected in their remuneration policies. Firms must also include information on sustainability risk integration in product pre-contractual disclosures.

**Principal adverse impact**
Firms must include a statement as to whether they consider principal adverse impact, i.e. the negative impact of their investments on sustainability factors, in their decision making. If yes, firms must disclose information about their due diligence policies and engagement practices. Large firms with more than 500 employees must disclose this information.

**Sustainable products**
SFDR distinguishes two types of sustainable products: products that promote environmental or social characteristics (often referred to as Article 8) and products that have as their objective sustainable investments (known as Article 9). Products falling into one of these categories must provide additional details setting out their sustainable investing approach.

In particular, the Regulatory Technical Standards (RTS) that underpin the implementation of key aspects of SFDR are still being formulated. The European Supervisory Authorities (ESAs) published their final advice relating to reporting on principle adverse impacts and Article 8 and 9 product disclosures in February 2021.

However, in May, a further consultation was launched on the Taxonomy-related disclosures under SFDR for funds marketed as green. With the stated aim to have a single consolidated set of rules, the European Commission is now waiting for the ESAs to conclude their work on this second phase in order to adopt the final rules, hopefully in the next few months. As a result of this relay, the European Commission announced in July that it would delay the implementation deadline for these rules from 1 January 2022 by 6 months, to 1 July 2022.

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While the delay will be welcome news to many firms, this should not be taken as a reason to take one’s foot off the gas when it comes to any implementation efforts. Since the deadline (1 January 2022 for some of the Taxonomy-related requirements) is hardwired into the legislation, financial market participants are likely to show progress, particularly ensuring a high-level principles-based effort to comply with the rules, even in the absence of the implementing rules. The ESAs have also, in a supervisory statement, called for firms to start considering the draft RTS during the interim period before they come into effect, with supervisors potentially looking to see additional detail that meets the requirements of the RTS for new product authorisations.

A key challenge of the new framework has been the lack of clarity and consistency as to how firms should categorise their Environmental, Social and Governance (ESG) funds as either Article 8 or Article 9, with firms taking very different approaches in the run up to the March implementation deadline. Despite the European Commission issuing a Q&A to try to address some of this uncertainty, ambiguity remains.

**Other local regulations**

To add to the complexity, a number of national regulators are increasingly moving ahead with their own national regimes for ESG products. In addition to the French Autorité des marchés financiers (AMF) rules that entered into effect in March, the German Bafin issued a consultation in August 2021 regarding introducing its own regime setting criteria for ESG products. Firms looking to distribute products cross-border are therefore likely to find it increasingly challenging to adhere to the various national regimes that are being introduced, leading to additional costs and market fragmentation. In an attempt to address this uncertainty and the risk of divergent national rules, the European Commission has announced, as part of its Sustainable Finance Strategy, that it will explore introducing minimum requirements for Article 8 products.

Linked to SFDR is the adoption of implementation rules to amend fund, insurance and distribution rules under Undertakings for the Collective Investment in Transferable Securities (UCITS), Alternative Investment Fund Managers Directive (AIFMD), Solvency II, Markets in Financial Instruments Directive (MiFID) and Insurance Distribution Directive (IDD) to integrate sustainability considerations into organisational requirements, due diligence, risk management, product governance and suitability rules. The rules were finalised in August 2021 and most will take effect in 12 months, in August 2022.

The most notable rules in the package relate to distribution under MiFID II. The rules require advisors to assess a client’s sustainability preferences as part of their suitability assessment. However, where a client has a sustainability preference, the rules define eligible products not with regards to the SFDR categorisation of Article 8 or 9 but with regards to 3 criteria:

- Minimum exposure to Taxonomy-aligned investments
- Minimum exposure to sustainable investments (as defined by SFDR)
- Consideration of principal adverse impact

While work is ongoing within the industry to develop a framework to make these new rules operational, product manufacturers distributing via banks and financial advisers subject to these new rules are likely to need to review their ESG product categorisation and product disclosures to ensure their sustainable product range can meet one of the above criteria.

**UK regulations**

While the UK has not onshored SFDR into UK law, the UK governments and regulators are moving ahead with their own approach to climate and ESG investing. As part of the UK government’s Task Force on Climate-Related Financial Disclosures (TCFD) roadmap, which aims to require TCFD disclosures across the economy by 2025, the Financial Conduct Authority (FCA) launched a consultation in June 2021 to introduce TCFD reporting to asset managers, insurers and pension providers. This complements rules on climate governance and reporting for occupational pension schemes that have been introduced by the Department for Work and Pensions (DWP). The rules would require firms to compile an annual disclosure in compliance with the TCFD recommendations, as well as to publish product-level climate metrics and scenario analysis.

Meanwhile, the FCA issued a “Dear CEO” letter in July setting out guidance on ESG product design and delivery to ensure that firms’ claims regarding sustainability are proportionate to the strategy. While separate to the EU’s SFDR, the UK regime is designed to be consistent with the EU framework so that firms subject to both regimes are not subject to conflicting obligations.

**Defining green**

In addition to SFDR, the EU's Sustainable Taxonomy is a core component of the EU's sustainable finance approach, with the aim of creating a clear and unambiguous definition of what constitutes a green activity. However, the European Commission's attempt to create such a definition for climate has been subject to fierce controversy, with climate activists criticising the rules as too lax while governments and industry lobby for standards that meet existing sustainable practices and the inclusion of transitional activities such as nuclear and gas.

Despite the controversy, the Platform on Sustainable Finance is already consulting on how to extend the Taxonomy framework, launching two consultations over the summer looking at whether to include a significant harm Taxonomy for brown activities and a social Taxonomy.

## Taxonomy

The EU Taxonomy aims to create a legally defined definition of environmentally sustainable activities. The Taxonomy defines 6 environment objectives: climate mitigation, climate adaptation, water and marine resources, pollution prevention, biodiversity and transition to a circular economy.

To be considered environmentally sustainable under the Taxonomy, an activity must:

1. Make a substantial contribution to one of the above objectives (with thresholds and criteria set out in detailed technical screening criteria)
2. Do no significant harm to any of the other 5 objectives
3. And meet minimum safeguards defined as meeting international responsible business standards under the OECD and UN frameworks

The Taxonomy also imposes disclosure requirements on product providers and listed companies. Products that are marketed as green will be required to set out which environmental objectives they contribute to and their alignment with the Taxonomy. Large, listed companies will be required to report how their business activities measure up against the Taxonomy.

Building on the Taxonomy, the European Commission also published a legislative proposal for an EU Green Bond Standard[1] on 6 July 2021. The Regulation lays down the foundation for a common framework of rules regarding the use and designation of "European Green Bond"/ "EU GB" for bonds that pursue environmentally sustainable objectives within the meaning of Taxonomy Regulation. The impact is yet to be seen and will depend on market take-up of the voluntary standards in line with the current and future Taxonomy criteria.

Lastly, with important international commitments expected at 2021 United Nations Climate Change Conference (COP26) this November, international coordination on sustainable finance is more important than ever. Work through the International Platform for Sustainable Finance[2] will play a role in exploring the possible harmonisation of taxonomies across important jurisdictions including the EU, the UK, China, India, Japan, Singapore, and others.

[1] EU Green Bond Standard proposal, https://eur-lex.europa.eu/resource.html?uri=cellar:e77212e8-df07-11eb-895a-01aa75ed71a1.0001.02/DOC_1&format=PDF

[2] European Commission, International Platform for Sustainable Finance, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/international-platform-sustainable-finance_en

To address this challenge, policymakers are increasingly introducing ESG reporting requirements on companies.

**Addressing the data gaps through corporate reporting**
A key challenge firms encounter, which will be exacerbated by the introduction of the above transparency requirements, is access to reliable and comparable ESG data. To address this challenge, policymakers are increasingly introducing ESG reporting requirements on companies.

The Commission's proposal for a Corporate Sustainability Reporting Directive[3] (CSRD) introduces mandatory, more prescriptive sustainability reporting obligations for firms, namely how sustainability affects the business and the impact of the business' activities on people and the environment (double materiality).

In addition, the proposal extends the scope of EU's sustainability reporting requirements to all large companies and all listed companies, including SMEs. All financial firms are also covered including banks, asset managers, and issuers. The European Financial Reporting Advisory Group (EFRAG) is responsible for developing draft EU standards on sustainability reporting and there will be proportionate standards for SMEs, which non-listed SMEs can use voluntarily.

Overall, this proposal plays an important role in addressing the lack of availability of standardized, reliable ESG data. The legislation is intended to promote increased transparency and to help investors gain access to investee firm's sustainability-related information. This said, there are also concerns that the legislation could create duplicative reporting frameworks for investors as they may have to report different ESG related information under different regulations.

In the UK, the Department for Business, Energy and Industrial Strategy (BEIS) issued a consultation on introducing TCFD-aligned reporting obligations for large public and private companies with more than 500 employees and £500m in turnover. This complements efforts undertaken by the FCA to introduce TCFD-aligned reporting for premium listed issuers and now standard listed issuers.

## The Taskforce on Climate-related Financial Disclosures (TCFD)

The Taskforce on Climate-related Financial Disclosures (TCFD) is a market-led initiative sponsored by the Financial Stability Board to promote more consistent and decision-useful climate reporting. The framework is based on 4 pillars:

**Governance** | **Strategy** | **Risk Management** | **Metrics and targets**

Over 2,000 firms globally have endorsed the recommendations of the TCFD, and it has quickly become the international standard when it comes to climate-related reporting. In June 2021, the G7 Finance Ministers committed to making TCFD reporting mandatory as part their efforts to achieve Net Zero.

At the international level, work has been continuing in several areas of sustainable finance, particularly with respect to sustainability reporting standards. The IFRS Foundation has now completed an initial feedback survey[4] on the development of a global sustainability reporting standard and is now amending the IFRS Foundation Constitution to accommodate an International Sustainability Standards Board (ISSB) to set IFRS sustainability standards. The IFRS' work on a new global sustainability reporting standard will be important to watch, particularly as the EU sets out complete its own bespoke sustainability reporting standard under the CSRD in tandem.

[3] Corporate Sustainability Reporting Directive, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189
[4] IFRS survey, https://www.ifrs.org/projects/work-plan/sustainability-reporting/

### Looking ahead

With all of the regulatory initiatives described above, policymakers are signalling even further regulatory changes, in some cases before the ink has dried on existing measures.

The European Commission presented its *Strategy for financing the transition to a sustainable economy*.[5] This Strategy builds on the aforementioned 2018 *Action Plan* and recent work carried out by the Platform for Sustainable Finance; the Communication sets out four high-level objectives which frame upcoming regulatory action:

1. Financing the transition to sustainability
2. Inclusiveness
3. Financial sector resilience and contribution
4. Global Ambition

Each of these areas has direct impacts for the investment firm's sustainability strategies, operations, and compliance. While the overarching agenda is important to remain aware of, specific initiatives warrant close attention, including a proposal on ESG ratings, a proposal on sustainable corporate governance, extension of the framework for sustainability standards and labels, empowerment of retail investors, and actions to address sustainability risks in the banking and insurance sectors. Planned initiatives under these areas will directly impact firm's sustainability strategies, operations, and compliance.

In the UK, the Chancellor announced in July, as part of his vision for the future of the City, that the UK will introduce new Sustainability Disclosure Requirements across the UK economy to require companies, financial services firms and pension schemes to disclose on climate and environmental issues. The UK will also work to introduce a sustainable product label. Further details on both of these are expected to be announced shortly in October.

## Key dates

### 2021

**1 October**
Entry into effect of TCFD governance and reporting obligations for UK occupational pension schemes with more than £5bn in AuM

**1–12 November**
UN Climate Change summit ("COP26") in Glasgow, UK

### 2022

**1 January**
Entry in effect of Taxonomy Regulation Level 1 in relation to climate change; entry into effect of TCFD disclosure obligation for the largest UK firms covering asset managers with more than £50bn in AuM and asset owners with more than £25bn in AuM and for standard listed issuers

### 2022

**1 July**
Implementation of SFDR RTS

**22 August**
Implementation of sustainability-related provisions for organisational requirements, due diligence, risk management and suitability under UCITS, AIFMD, MiFID II, IDD and Solvency 2

**1 October 2022**
Entry into effect of TCFD governance and reporting obligations for UK occupational pensions schemes with more than £1bn in AuM

### 2022

**22 November 2022**
Implementation of sustainability-related provisions for product governance under MiFID II

### 2023

**1 January**
Entry into effect of Taxonomy Regulation Level 1 in relation to non-climate environmental objectives; entry into effect of TCFD disclosure for all in-scope firms with more than £5bn in AuM; proposed entry into effect of Corporate Sustainability Reporting Directive

### 2023

**30 June**
Deadline for first reports under TCFD for largest financial firms

### 2024

**30 June 2024**
Deadline for first reports for smaller firms subject to TCFD reporting in the UK

Visit Invesco's websites for more information on ESG investment insights, register for our ESG regulatory and implementation webcall, or learn about Invesco's corporate ESG policies.

[5] Strategy for financing the transition to a sustainable economy, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0390

**Risk warnings**

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

**Important information**



**Further information on our products is available using the contact details shown.**


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