

Summary of the EU Sustainable Finance Regulation

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Already 50 years ago, scientists from the Massachusetts Institute of Technology (MIT) pointed out the consequences of exponential growth in our economic system in their report to the Club of Rome "The Limits to Growth"¹. But for a long time, nothing happened. On the contrary, during the Reagan and Thatcher administrations, markets were deregulated, which further accelerated growth. When the financial markets were liberalised under Bill Clinton at the end of the 1990s, they virtually exploded, thus preparing the ground for the (financial) crises that followed.

At the same time, however, the first steps were taken to counteract this foreseeable development. In 1999, for example, the **UN Global Compact**² was founded to make globalisation more social and ecological. In the same year, the first reporting framework of the **Global Reporting Initiative**³ (GRI) was created.

At the beginning of the 21st century, regulation on sustainability gained momentum and, at the latest with the **UN Principles for Responsible Investments**⁴ (2006), the topic also moved into the focus of investors. Two years earlier, **environmental, social and governance (ESG)** was mentioned for the first time in the "Who Cares Wins" report⁵. This report called for the inclusion of ESG criteria in the financial assessment of companies in order to further develop sustainable investments.

With the adoption of the **Paris Climate Agreement**⁶ and the **UN 2030 Agenda** for Sustainable Development⁷ in 2015, governments from around the world decided to chart a more sustainable path for our planet and our economy. At the heart of the UN 2030 Agenda are 17 **Sustainable Development Goals**, (SDGs).

An important first step towards sustainability reporting at the European level was the adoption of Directive (EU)2014/95⁸ on the disclosure of non-financial and diversity information by certain large companies and groups, also known as the **Non-Financial Reporting Directive (NFRD)**, in 2014. It was transposed into national law in Germany with the **CSR Directive Implementation Act**⁹ (CSR-RUG) in 2017.

Already the year before, at the end of 2016, the EU Commission had set up a **High-Level Expert Group (HLEG)** on Sustainable Finance. On 31 January 2018, this group published its **final report**, in which it presents a comprehensive vision for the

1 https://en.wikipedia.org/wiki/The_Limits_to_Growth

2 <https://www.unglobalcompact.org/>

3 <https://www.globalreporting.org/>

4 <https://www.unpri.org/>

5 https://d306pr3pise04h.cloudfront.net/docs/issues_doc/Financial_markets/who_cares_who_wins.pdf

6 <https://www.un.org/en/climatechange/paris-agreement>

7 <https://unsdg.un.org/2030-agenda>

8 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&qid=1648035195026&from=EN>

9 <https://www.bmjv.de/SharedDocs/Gesetzgebungsverfahren/DE/CSR-Richtlinie-Umsetzungsgesetz.html>

development of an EU sustainable finance strategy. The report contains two urgent demands for sustainable finance:

1. Improve the contribution of the financial sector to sustainable and inclusive growth by financing the long-term needs of society;
2. Strengthening financial stability by considering environmental, social and governance (ESG) factors in investment decisions.

To facilitate the transition to a more sustainable economy, the EU Commission published on this basis in the same year the **EU Action Plan: Financing Sustainable Growth**¹⁰, with three targets and ten actions to achieve them (see Figure 1). This then also became part of the **European Green Deal**¹¹ announced the following year (2019).

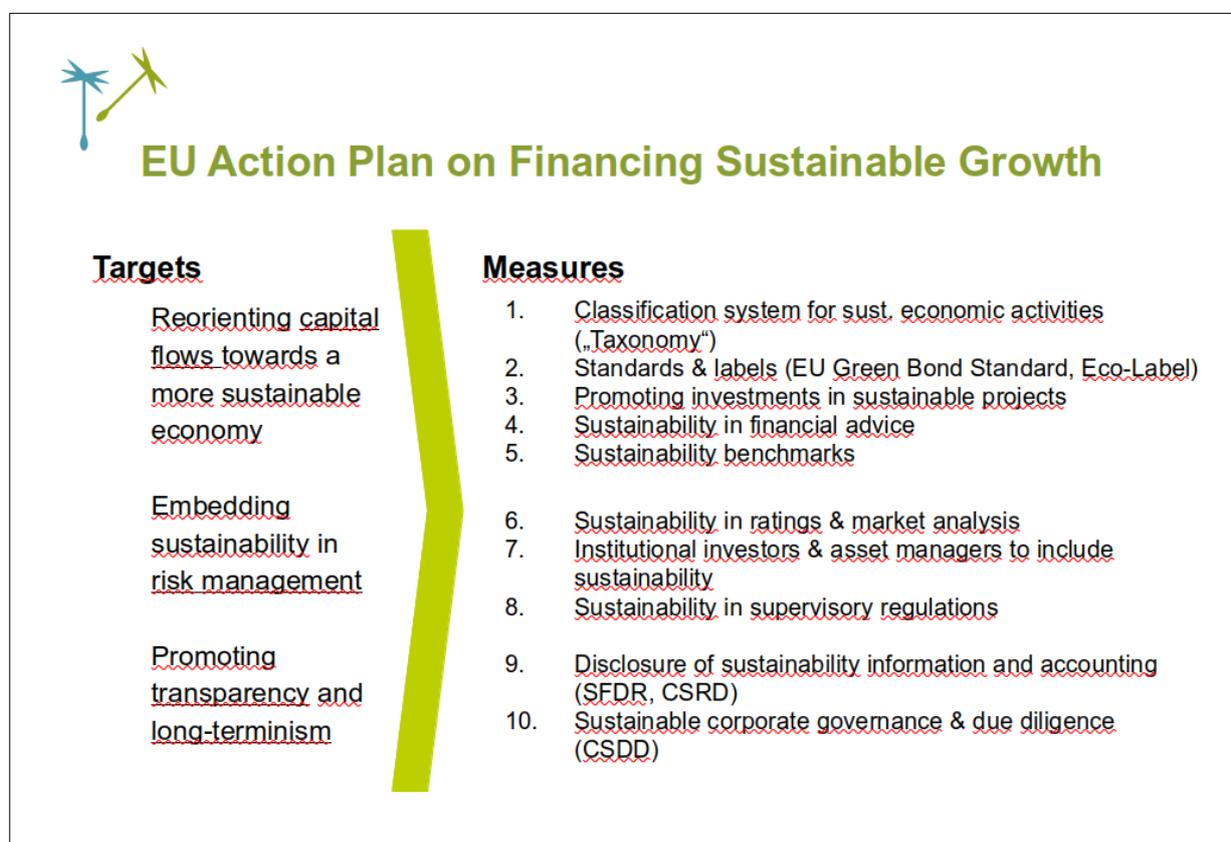


Fig. 1 Objectives and measures of the EU Action Plan: Financing Sustainable Growth

The implementation of the measures from the Action Plan resulted, inter alia, in Regulation (EU) 2019/2088 on **sustainability-related disclosure requirements** in the financial services sector (**SFDR**)¹² and Regulation (EU) 2020/852 on establishing a framework to facilitate sustainable investment (**Taxonomy**)¹³.

10 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&qid=1648035467238&from=EN>

11 https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

12 <https://eur-lex.europa.eu/eli/reg/2019/2088/oj?locale=en>

13 <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32020R0852>

In April 2021, the EU Commission adopted the proposal for a directive on the amendment of corporate sustainability reporting - **Corporate Sustainability Reporting Directive (CSRD)**¹⁴ - which will comprehensively change the existing reporting obligations of the NFRD. The proposed directive also aims to significantly expand the group of companies subject to reporting requirements and introduces binding European reporting standards that have yet to be developed.

After individual EU member states introduced or announced regulations on due diligence - e.g. Germany in June 2021 with the Law on Corporate Due Diligence to Prevent Human Rights Violations in Supply Chains (LkSG)¹⁵ - the EU Commission reacted on 23 February 2022 by proposing the **Corporate Sustainability Due Diligence (CSDD)**¹⁶ Directive to introduce an EU-wide due diligence obligation for companies to address negative impacts on human rights and the environment.

Outlook

The CSRD proposal is currently being negotiated with the EU Parliament and the European Council and is expected to enter into force this year. Subsequently, the member states still have to transpose the directive into national law so that it becomes effective for companies. According to the current timetable, the regulations should apply from 1 January 2024 for the 2023 financial year. It is expected that the timetable will be pushed back by one year, as both the EU Parliament and the European Council are proposing a delayed introduction.

The EU Commission has commissioned the **European Financial Reporting Advisory Group (EFRAG)** to develop the future European reporting standards. In order to promote international convergence in the area of sustainability reporting, an exchange with international initiatives is also to take place.

The first core standards are to be completed by mid-2022 and adopted by 31 October 2022. Further sector-specific standards and a simplified version of the standards for SMEs are to be available by 31 October 2023 at the latest.

In this context, companies should prepare for the coming requirements now if possible and already work on the strategy for sustainable business as well as develop the necessary concepts for reporting.

In order to comply with the regulation from Brussels, a working group "Quality Circle" has been formed for the ECG, whose actors (members from MET, Audit, Consulting, and Companies hubs) focus on reviewing the requirements and coordinating the necessary measures.

This results in three essential fields of action for the orientation of ECG:

1. Further development of the ECG standard
2. Accreditation of the ECG audit

14 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189>

15 <https://www.gesetze-im-internet.de/lksg/index.html>

16 https://ec.europa.eu/info/publications/proposal-directive-corporate-sustainable-due-diligence-and-annex_en

3. The development of a basis for communicating the added value that ECG offers beyond the EU standard.

It is particularly important to always keep in mind the unique selling points of ECG as a pioneer of social change towards responsible, cooperative coexistence within the framework of ethical business.

The main building blocks of the EU Sustainable Finance Action Plan in detail

Taxonomy Regulation

The EU Taxonomy came into force on 12 July 2020. Like all EU regulations, it no longer needs to be transposed into national law, but applies equally in all member states as soon as it enters into force. It is one of the core pieces of the EU sustainability package and defines environmentally sustainable economic activities. In order to be considered sustainable according to the Taxonomy Regulation, an economic activity must

- make a significant contribution to achieving one or more of the six EU environmental objectives
- do not cause significant harm to one or more of the other environmental objectives (DNSH)
- is carried out in compliance with given minimum safeguards, and
- meets the specified technical screening criteria.

The EU Taxonomy Regulation will lead to **new disclosure requirements as early as 1 January 2022**, both for financial market participants offering financial products in the EU and for companies obliged to report non-financial information under the NFRD (CSR-RUG in Germany). Accordingly, financial market participants who want to market a financial product as sustainable are obliged to report on the taxonomy-compliant share of their investments in the portfolio. In future, companies that fall under the NFRD must provide information in their non-financial reports on how and to what extent the company's activities are economic activities within the meaning of the Taxonomy Regulation.

Disclosure Regulation (SFDR)

The SFDR is an EU regulation on the disclosure of information by financial market participants on the sustainability of their investment decisions and entered into force on 31 December 2019. The Disclosure Regulation is also a **legal act with general application and direct effect** in the member states and thus there is no need for national legislators to transpose it into national law.

According to Article 20 (2), most of the provisions of this Regulation will apply to the financial service providers concerned as of 10 March 2021. Accordingly, EU fund managers as well as investment firms offering portfolio management or investment advice are obliged to disclose how they take sustainability risks into account in their investment processes and products and how they deal with the main negative impacts - **Principle Adverse Impacts (PAI)** - of their investment decisions on sustainability factors.

In addition, fund managers of funds that advertise environmental or social features (Art. 8 SFDR, so-called Light Green Funds) or pursue a sustainable investment objective (Art. 9 SFDR, so-called Dark Green Funds) must also disclose information on how these features and objectives are achieved and measured.

Corporate Sustainability Reporting Directive (CSRD)

The CSRD proposed by the EU Commission in April 2021 is a fundamental revision of non-financial reporting by companies. After its adoption at EU level, the directive must be transposed into **national law by 01 December 2022** in order to become effective for companies. The new regulations should then apply from **01.01.2024 for the 2023 financial year**.

According to the proposed directive, all large companies with an annual average of 250 employees or more will be obliged to report if they also meet the second threshold for large companies, a balance sheet total of more than 20 million euros or a turnover of more than 40 million euros, regardless of their capital market orientation. All capital market-oriented small and medium-sized enterprises, with the exception of micro-enterprises, are to be added from 01.01.2026.

With the implementation of the proposal, a double materiality is to be anchored, which changes the principle of materiality that has been applied so far, especially in Germany. According to this, matters are to be classified as material if they are material either for the business success or from an environmental or social point of view. Up to now, both have to apply to the non-financial statement, which, if strictly interpreted, means that only very few matters are subject to reporting requirements.

In addition, the proposal introduces binding European reporting standards, which, however, still need to be developed. These are to be composed of sector-independent, sector-specific and organisation-specific standards. For SMEs, a simplified version of the standards is to be created, which corresponds to the possibilities of these companies as well as the relevant stakeholder expectations of sustainability information. At the same time, a digital taxonomy for machine-readable reports is to be developed as another important building block.

Corporate Sustainability Due Diligence Directive (CSDD)

The EU Commission's proposal for the so-called EU Supply Chain Directive introduces a **due diligence obligation for companies in the area of sustainability** that addresses negative impacts on human rights and the environment. In concrete terms, this means more effective protection of human rights enshrined in international conventions. For example, workers should have access to safe and healthy working conditions. In addition, this proposal should help to avoid negative impacts on the environment that are in contradiction with important environmental conventions.

The new due diligence requirements are to be applied both by large EU companies with limited liability and by certain companies from third countries. These include, on the one hand, EU companies with more than 500 employees and a turnover of at least €150 million (Group 1) and, on the other hand, EU companies from certain high risk sectors with more than 250 employees and a turnover of at least €40 million, with at least 50% of turnover coming from these sectors (Group 2). The high risk sectors

defined in the draft directive include, among others, the textile industry, agriculture or the extraction of raw materials. For German companies, the draft directive thus assumes a scope of application that goes beyond the German LkSG.

In addition, non-EU companies operating in the EU with a turnover corresponding to the thresholds of groups 1 and 2 and generated in the EU will be included in the scope. Small and medium-sized enterprises (SMEs) do not fall directly within the scope of this proposal.

The proposed Directive applies to companies' own operations, their subsidiaries and their value chains (direct and indirect business relationships). In order to comply with corporate due diligence, companies must:

- Make due diligence an integral part of their corporate policy,
- Identify actual or potential negative impacts on human rights and the environment,
- Prevent or mitigate potential impacts,
- Eliminate or reduce real impacts to a minimum,
- Establish a complaints procedure,
- Monitor the effectiveness of due diligence policies and measures.
- and communicate publicly the exercise of their due diligence responsibilities

Group 1 companies must also demonstrate how their corporate strategy is in line with the 1.5 degree target of the Paris Climate Agreement.

In addition, according to the draft guidelines, the management of the companies concerned will be required to ensure the implementation and monitoring of due diligence and the integration of sustainability efforts into the corporate strategy. Furthermore, in addition to their duty to act in the best interests of the company, they must consider the human rights, climate change and environmental consequences of their decisions. If there is variable remuneration for executives in the company, it should include incentives to contribute to mitigating climate change.

Unlike the German LkSG, the European proposal provides for sanctions in case of non-compliance as well as civil liability in case of violations.