SFDR/CSRD/Taxonomy: usability challenges and expected impacts

A regulator welcomed participants to the panel, which will provide clarity on data, sustainability, and reporting. In order to make progress on sustainability, data is key, and in order to have this data it needs to be reported.

1. Progress and difficulties in the implementation of SFDR

A regulator stated that it has been a year and a half since the Sustainable Financial Disclosure Regulation (SFDR) became applicable, and many lessons have been learned since that period. The SFDR is a very important piece of the regulatory framework on sustainable finance, since it has increased transparency and provided investors information on sustainability risks of the investment product, and on sustainability claims of investment products made by market participants.

When looking at the data and how the environmental, social and governance (ESG) market is growing, there is a need for this regulatory framework. Despite the net outflows seen in the last couple of months due to the economic situation, the percentage of the ESG market, in terms of assets under management at the EU level, remains quite stable at around 27%. This transparency and framework was needed.

There are three main challenges from a supervisory point of view. The first is a risk of discrepancies in application of the regulation among jurisdictions due to the lack of clarity. There is a risk among firms, but there needs to be awareness that there is a risk among jurisdictions. There is still no good understanding of what an Article 8 fund means or what minimum criteria it should follow. That is very important because. In a country such as Spain, more than 40% of promoted investment funds come from other jurisdictions. This might lead to an unlevel playing field or a lack of comparison for investors. The European Securities and Markets Authority (ESMA) is doing an admirable job and there is still a major role to play in terms of supervisory convergence.

The second challenge come from investor difficulties in understanding the information published by entities. One example of this is the use of ESG terms in the name of a fund (such as green, sustainable, or social) in a way that might not reflect the investment characteristics of the fund fairly. All this could result in the third risk, the risk of greenwashing. There needs to be a further focus on greenwashing.

An industry representative stated that the SFDR was welcomed, especially to prevent greenwashing, to provide comparable information and to increase transparency on certain sustainability aspects. However, it also brings many challenges for the implementation. The SFDR framework is extremely complex and certain required data (e.g., on Taxonomy-alignment of investments or PA-KPIs) is not available. There are also issues with different interpretations between the different regulations (e.g., MiFID II, SFDR and Taxonomy). The documents that need to be produced are very complex. It is questionable whether the detailed disclosures on sustainability are proportionate to the benefits for investors. There needs to be more clarity, significant simplification and better coherence of the respective regulatory framework.

2. Difficulties raised by the EU taxonomy

A regulator commented that part of the role of SFDR is to prevent the risk of greenwashing. On the European level an additional step has been taken to develop a taxonomy. Overall, the taxonomy is a step forward to create clarity on what is and what is not green, thereby supporting the market.

An industry representative stated that the taxonomy is clearly the first step on the sustainable finance agenda. The taxonomy reporting will show which assets are eligible and which assets are not. The first reporting season in the banks has shown the weaknesses and challenges of KPIs. The green asset ratio (GAR) for instance is affected by size and business model of financial institutions, meaning it only takes into account what is eligible, while other assets and exposures are being disregarded. Of the banks represented by the representative, 25% to 65% of their portfolios are eligible. The other 35% to 75% are non-eligible. The range for other banks are the same. In the end, it does not show the right result, although there are many loans to small and medium sized enterprises (SMEs), supporting the way to more sustainability. It is transition finance that is not shown in the taxonomy and the green asset ratio.

In addition, eligibility differs widely by sector. In automotive, 90% of the assets are eligible. In a chemical or pharmaceutical sector, just 11% of the assets are eligible. Simple KPIs have limited usefulness as steering parameters and should therefore not be used in any supervisory or regulatory requirement.

3. Challenges for financial institutions and corporates to implement EU regulation

An industry speaker explained that, having helped clients ascertain what is required from them, it is extremely challenging for financial institutions and corporates to make sense of the different pieces of regulation and how they complement each other. There is a lot of confusion around how all the different pieces fit together and how one bit can be leveraged to work with another. This is particularly challenging for the financial institutions as they depend on the information provided by real economy players.

The data is hard to access because it has to be collected from several counterparts who are not equally mature and concerned by the information and it is provided in many different formats. Whilst the quantitative information is easy, there is a lot of qualitative information which will vary in terms of what is provided and will be hard to input into a system. In terms of useability, it is the beginning of the journey. A lot of improvements need to be made. The Corporate Sustainability Reporting Directive (CSRD) will be a game changer as it will help with the standardisation of information.

The other challenging bit is to make sense of how to use the information and how it will influence a business. There tends to be a focus on a tiny bit of data, and players are struggling to embrace what this means for their business today and in the future. It is more than just data.

A regulator stated that the industry is working on the challenges, and there are many questions as there is a willingness to do it right. There is also a sense of reputational risk if a business does not get this right which is providing extra pressure. A regulator commented that CSRD will definitively be a game changer however, it is not in place yet.

4. CSRD is welcome but also challenging

A regulator very much welcomed the CSRD. It is the piece of the regulatory framework needed in order to have all the data and information for the rest of the investment value change and sustainable finance. The problem is it will take time to implement. So far, the assessment is quite positive. It will enable investors to be able to assess the long-term value creation of a company, as well as how the economic activities on the undertakings contribute to a more sustainable economic development.

The approach is grounded in the double materiality concept of the EU. It broadens the scope of data and number of undertakings subject to sustainable reporting. It introduces the need of assurance from a third party. And it also stablishes the European Sustainability Reporting Standards.

There is no doubt that undertakings will have challenges in fulfilling the new requirements and that there is room for improvement.. Everything possible should be done to simplify without diminishing the EU ambition regarding the materiality approach. In addition, the rebuttable materiality approach is also unconvincing. There are maybe some ways to make it more similar to what exists in financial reporting. It is also crucial that there is a high level of assurance with the data, as the data will form the input for the rest of the value chain. To that end, undertakings should also have in place high-level quality internal control systems.

Regulators only review the information published by listed companies, which in Spain represents only 5% of the companies publishing non-financial information. There needs to be a strong framework around the assurance to ensure the quality and consistency of the data.

An official commented that the EU started with regulations that needed data. To a certain extent, they should have started with the CSRD. It was a political decision, and there was a big push to mobilise the energy of sustainable finance. CSRD's biggest interest is to put things in the right order. In terms of quality data it is moving in the right direction. This will probably not be too easy. Some believe it is too fast, whilst others believe it is not fast enough. Uses believe that they need information quickly.

The second point is to stimulate consistency. Financial reporting follows decades of standard setting, long discussions about new standards and a long period of implementation. Europe is confronted with an urgency, and as such, sustainability reporting must become the second pillar of standardised corporate reporting, on an equal footing with financial reporting, as quickly as possible bearing in mind the implementation difficulties that need to be overcome. The EU and financial institutions within the EU will benefit from such a move. It might look like creating an unfair playing field with other jurisdictions, but it is a good idea to be front running in innovative systems.

Consistency is key, which is why the SFDR disclosures were introduced in the standards. They are as comprehensive as possible because there was a feeling that without this information from the corporates, in the scope of the CSRD, it will be pretty difficult to make sense of the disclosures. While consistency is the key word, one also has to bear in mind quality. If there is a desire to have financial reporting and sustainability reporting on an equal footing, there needs to be a focus on five information qualities that are pivotal. The first is relevance. One should give a faithful, unbiased representation of information that is decision-useful and properly depicts the phenomenon that it is intended to be described. One piece of information may be relevant but not all the information that is needed. There is then comparability, which is of course key because decisions are made by comparing peers in sectors or globally. There is then understandability and verifiability because, ultimately, the level of assurance that will be given on the information, a key feature of the CSRD, is going to give credibility to the system.

An industry representative stated that the CSRD is good, especially from an industrial point of view. However, it is not easy to implement. The CSRD shows proportionality. This makes things easy and understandable and shows the reality. With the change from the Non-financial Reporting Directive (NFRD) to the CSRD, the company base increased from 10,000 to 50,000. Asking the companies that are new to the scope to provide data needed to get clarity will be a challenge. There is still work to do and a lot of information needs to be produced on different levels.

An example is one simple report that required 600 requirements and 170 quantitative data points. Upon seeing the result of such a report, one would question whether the information is relevant. The CSRD is a really good starting point when it comes to integrate proportionality into the sustainable finance framework, and it is hoped that it is a blueprint for a future regulation for sustainability.

An industry representative observed that those who were initially most critical of the CSRD are now saying it may be a good thing. It will help standardise information and set the expectations. It creates some transparency and clarity on what is expected from everyone. Whether it is or is not reasonable is a different debate.

Larger companies familiar with providing such information are taking a deep breath as the extent to which the information must cover the entire value chain is raising several challenges. There is a worry about how to source good quality data. There is also a realisation that the data will not be 'thrown in a box' but be the result of a long process, including interacting with stakeholders and identifying what is material to them. This is a process that links back to identifying risks, impacts and opportunities. The data has to make sense. It is the result of an entirely new process, and at the core one needs to know what is or is not sustainable for them and their stakeholders. Individuals in different departments are required to build on new capacities and competencies. This is preconditioned to good quality data. You need to build the muscles to be able to both source the data and pick the relevant one, though this has been overlooked.

Now that CSRD is being implemented, it has been realised that this is not just a 'tick-box' exercise. In order for data to be accurate, it must be understood why it is being provided and this would be an additional challenge. Previously the industry and regulators learned to walk on one leg, but now are asked to walk on two; it is a whole new exercise.

A regulator noted that good data is much more than just a number. It is a process which includes knowledgeable people, knowing where to get the data and supervision.

5. The EFRAG proposal of sustainability standards should be simplified and progressively implemented

An official stated that it is too early to provide final conclusions. The deadline for the consultation was 8 August, and EFRAG received approximately 500 responses which were currently being analysed. This will not be an easy exercise. When organising the consultation, EFRAG asked stakeholders if, should this requested information be provided, it should be relevant, decision-useful, and faithful. The CSRD is not a 'tick-box' exercise. There has to be a real assessment of impacts, risk and opportunities.

Within a report produced in 2019 there were three big advantages to sustainability reporting: better internal decisions, the creation of good relationships with all stakeholders, and investors among stakeholders funding a transition. There are a number of remarks on the proposal, as regards to the relevance, because when putting together a taskforce of specialists and they will be asked what they think, and they will of course have designed the perfect expectations in answer. Officials probably, and most certainly, reduce their ambition because they do not want to overdo it. For example, in the social domain, it is probably not necessary to disclose the allocation for each and every entity over and above 50 employees. There are good reasons to say it would be useful, but the circle of people for whom it is useful is maybe too limited and that could be provided through other channels.

The consultation has received remarks on relevance. Certain topics are less mature than others. Biodiversity is a good example because it is one of the topics that is certainly moving forward quickly.

For certain specialists there will be an arbitration, but I think the arbitration will be in the sense of reducing what is relevant, which is very different from financial reporting. There are a series of topics while in financial reporting, there is one measurement: monetary units and summary statements that are called balance sheet and profit and loss. Equity or profit is not going in the right direction. In sustainable reporting, there are 12 topics to address, depending on the materiality assessment.

Once relevance is assessed, there are the difficulties to implement. There was a cost-benefit analysis because EFRAG needs to know how fast it is possible to go. You do not compromise on the ultimate objective, but you give time or you create optionality for the most advanced that will use and show the way, but others say they need more time.

An industry representative commented that at beginning of the session, there was discussion about taxonomy, and it would be great if EFRAG could prioritise the work, focusing on the climate issue, and then aligning with the other regulations and use the lessons learned from the market. An official explained that climate is considered a priority. EFRAG is making a huge effort, as is the International Sustainability Standards Board (ISSB), to avoid multiple reporting on climate. As regards to the Securities and Exchange Commission (SEC), it is not so much that EFRAG has different views, but it does not know if the project will go all the way, due to the political context. Though dialogue with the SEC is good, it is more detailed with ISSB, with certain hurdles to jump over.

However, CSRD is asking for more comprehensive reporting. EFRAG is a standard setter, but the Commission is of course applying what the co-legislators have decided. It is not bad news, but this is at least the constraint to understand.

The direction of travel established by the CSRD is pretty clear. There is a goal to reach a certain destination, but the speed is still to be discussed, depending on the political definition of what is a large entity in the EU. Supervisors cannot make a distinction between the very large and the smaller or large. There will be a question of alignment. If it is so easy for the very large, and already difficult for the smaller, there is an issue. SMEs also should be encouraged to adopt the system because the economy is not only the large entities.

A regulator noted that when thinking about the investors, as an official mentioned, simplifying and looking for ways to reduce the amount of information will help to reduce the gap between information supplied and information used. It is essential to always take into account the perspective of investors, the ones who are going to use the data, in addition to the perspective of the undertakings who supply this data.

6. The role of supervisors and of assurance and internal controls

A regulator highlighted that companies need to be ready to have procedures and resources to ensure data's reliability. The new framework is complex for everybody, but it is much needed. Supervisors also need to be sure that the data, that will be the input for the rest of the investment value chain in sustainable finance, has the quality needed.

There is a challenge in ensuring high level of assurance by third parties. For the first seven years, assurance will be limited. Anything that can be done to enhance and ensure a better framework for the assurance providers is welcomed.

An industry representative stated that regulators should take into account the learnings of the last one or two years of trying to implement the first standards, to work on the future standards. Authorities, regulators and the industry are facing more or less the same challenges, and everybody is having more or less the same learnings. In the end, everybody has to connect. The sustainability agenda is not only a European thing. It will connect the world together. Communication is one of the key points: a dialogue from the banks, the regulators and the companies. There of course needs to be more simplification in the standards and really good standards that are easy to apply instead of the best standards that are difficult to apply.

An industry speaker explained that everyone is on a learning curve and a journey. There are serious resource constraints in terms of numbers of people who actually understand what is going on and what needs to be done. There is a lot of benefit in being transparent and sharing the struggles and challenges, and the big and large victories, because this is how to learn from each other and manage the expectations of all stakeholders.

There are a lot of expectations from the markets about what systematic assurance on all that information will actually bring in terms of value for the market. In the CSRD there is a provision that says it is going to be limited assurance for the first few years before considering moving to reasonable assurance. This begs the question of what the limited assurance will look like.

It has been mentioned that it is all about negative assurance and that it has nothing to do with the positive assurance provided on financial information and queried how to reconcile the two. It will not be reconciled before a few years because the industry and regulators must learn to walk and mature standards at a reasonable pace so that practitioners can actually keep pace with that.

It will be really critical to achieve all of that, including assurance, with a logic and perspective of continuous improvement and learning, not looking at this as a one-off punitive. No one will be 100% ready, even if the standards are amended to make them less demanding. It will be key to be transparent on where progress is and how practitioners or preparers are going to change things and do things to meet the endgame requirement. It is critical that authorities are not too punitive and demanding. It is necessary to learn fast and some will stumble and fall.

An official stated it is good to have ambitions. In 2002, it took European businesses three years to move to the International Financial Reporting Standards (IFRS). This was a significant investment which should not be underestimated. Every business, including SMEs, should understand that this is crucial for the future and that it is not just a regulatory constraint. It is something that is much needed for the transition of the economy, and as a consequence, everybody should take the exercise very seriously. Standard setters will do our part by simplifying it and making it progressive.

A regulator commented that the timeframe on which EFRAG is working to develop the European standards is short and very challenging, but there should be every effort to do everything possible in time. Sustainable reporting is the input much needed for the other pieces of regulatory framework. Work should continue to finalise it as soon as possible.