CLARITY AND RELIABILITY OF THE SUSTAINABILITY FRAMEWORK

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Preventing greenwashing by legal clarity and robust data

The market for financial products with an ESG focus is growing steadily and has blossomed from a niche existence into a well-established and significant segment of the financial market. ESG products are not only structured for a specific group of investors, but for retail, professional and institutional investors alike. Greenwashing is therefore a main concern as it presents a threat to the trust of investors, the EU as a credible standard setter, and efficient transitioning towards a sustainable capital market.

Given the significant proportion of this market sector and the rising demand for ESG products, some product manufacturers might be tempted to put on a green cloak. With the development of clear requirements and a more robust data landscape, as regulators we see an increasing number of indications that demonstrate products' failure to live up to their sustainability promises. We are obliged to react effectively to such threats, to ensure that truly sustainable products are offered to investors and that market participants complying with the rules benefit from doing so.

Moreover, the European Sustainable Finance framework should not be treated as merely optional. Therefore, we also need to consider how to address green bleaching when firms understate the quality of sustainable products to avoid regulatory requirements.

At European and national level, massive steps have been taken to create a common understanding regarding product classifications. These requirements will be further refined over the upcoming years and demonstrate the importance of cross-sectoral, coordinated actions of the ESAs and the NCAs.

The NCAs in close cooperation with the ESAs will leverage on the proven method of complementing the implementation process of Level I with suitable convergence tools. We will continue to work hard on drafting further purposeful guidance, e.g., on fund names, and to closely monitor the implementation progress of both the NCAs and the industry with ESMA's Common Supervisory Actions.

Sustainable finance is an ongoing endeavour, not a one-off effort.

With a short-term perspective, guidance by the ESAs and NCAs helps to mitigate the most pressing legal uncertainties. But we also need a change in the regulatory framework to definitively clarify the requirements of what constitutes a "sustainable investment". Different public and private labels in use today give some indication of the specificities of the ESG products, but our next medium-term regulatory milestone should be an agreed and well-established European label.

The sustainable finance project also demands market participants' full buy-in. It is insufficient to rely on regulators to create a fully-fledged framework and then to mope about the complexity of ESG integration. The industry must step up to provide coordinated ideas and initiatives on how to facilitate an effective and efficient market for sustainable products. ESG integration should be seen as an economic opportunity, rather than as a regulatory cost.

Furthermore, we must ensure that we possess the relevant tools. The data to assess the performance of assets and the underlying companies needs to be robust and allow for comparability. Sustainability reporting standards under the CSRD framework will enhance the data quality and data availability. This information will allow for a meaningful analysis of companies seeking funding from the capital market and significantly boost our efforts for a sustainable economy.

ESG rating providers and ESG data providers play a pivotal role in granting access to information on the impact of capital to its ESG objective. For that reason, we need to have a clear picture about the size, structure, business operations, methodology and funding of ESG rating and data providers. Considering the influence and market power of such providers, I fully support the European approach on supervising these entities.

ESMA as a direct supervisor can best promote a consistent level of transparency around how ESG factors are considered. Equally, the robustness of ESG data will foster trust and allow for meaningful analyses of the ESG European market.

Sustainable finance is an ongoing endeavour, not a one-off effort. Let us all work together to achieve our common goals: a clear regulatory framework, a consistent understanding and a convergent application of the relevant provisions.

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The EU sustainability-related regulatory framework: looking ahead

The EU "sustainable finance" legislative framework is still in the process of being implemented, but a set of key regulations have already entered into force, such as the Sustainable Finance Disclosure Regulation Level 1 (SFDR) and Level 2 texts (Regulatory Technical Standards) and the Taxonomy Regulation (TR). SFDR and TR are important milestones towards building and enhancing transparency for investors on Environmental, Social and Governance (ESG) characteristics of financial products and thus contributing to channel private investment into the transition to a climate neutral economy, as a complement to public funding.

The objective of SFDR and TR is also to improve the comparability between financial products having ESG characteristics, notably through the implementation of standardised disclosure requirements on how Financial Market Participants (FMPs) intend to meet/have met those ESG characteristics.

The nascent nature of the sustainable finance package nevertheless triggers important challenges for stakeholders, some of those challenges requiring an immediate response, in that they may contribute to increase the threat of greenwashing and thus call into question the credibility of the sustainable finance package. Such examples include a clear definition of sustainable investments under SFDR, further specifications for financial products disclosing under SFDR Article 8 and Article 9 and addressing interlinkages between TR and SFDR.

On the topic of the definition of "sustainable investment", the European Commission has recently granted increased flexibility to FMPs, requiring them to carry out their own assessment of each investment and hence disclose the corresponding underlying assumptions. While this approach comes in with benefits, it also has caveats, one of them being the potential to hamper comparability of financial products offered to end-investors.

The sustainable finance package nevertheless triggers important challenges call into question the credibility of the sustainable finance package.

In addition, FMPs are currently given an important flexibility on the granularity of the disclosure on the "*underlying assumptions*", in particular on the details of the methodology used (for example, thresholds under the pass-fail or revenue-weighted approach), such that investors may not always be in a position to make a sufficiently informed decision on the proposed investment.

A lack of specification on the underlying criteria of what constitutes a "sustainable investment" also appears dichotomic in comparison with the very detailed requirements of TR regarding the definition of Taxonomy aligned activities, while keeping in mind that Taxonomy-aligned activities systematically qualify as sustainable investments under SFDR. In addition, there are key differences between concepts common to SFDR and TR, like for example the level at which the "Do No Significant Harm" assessment (activity v/s entity level) needs to be performed.

Further work towards a better alignment of the different regulations to reflect the commonalities of the underlying concepts to the sustainable finance framework thus appears fundamental. Clarifying those concepts is a real mainstay ahead of defining a consistent and comprehensive approach et EU level to address greenwashing.

Additional work on minimum criteria which would allow the disclosure under SFDR Article 8 and Article 9 is also needed (for example, investment thresholds). While the European Commission has clarified that under SFDR Article 9, financial products shall only be invested in sustainable investments except for cash and hedging, the requirements regarding SFDR Article 8 are far less specific, which means that the spectrum of financial products disclosing under SFDR Article 8 is currently broad, such that it can become difficult for investors to navigate through - and compare - those products. Having said that, appropriate safeguards shall be implemented to ensure that SFDR remains what it was always meant to be, that is, a disclosure regulation.

Enhancing the workability of the sustainable finance rulebook also means that disclosure templates shall be further simplified and standardized to ease a comprehensive disclosure to end investors and most importantly retail investors.

Finally, supervisory convergence remains key for the implementation of the sustainable finance package, also when it comes to addressing greenwashing concerns. Hence, the EU shall remedy those initiatives which may create market fragmentation such as the introduction of national "top up" SFDR and ESG rules and regimes, or differences in the application of SFDR for different financial products (like fund names). Because such fragmentation puts into question the good functioning of the European passport for investment products, and thus the EU Single Market in those areas.

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A big step for ESG data as sustainable finance's enabler

According to LSEG research, 60 000 companies will be subject to CSRD reporting including more than 10 300 non-EU companies. Regulation of ESG data through CSRD will substantially change – for the better - the sustainable investment landscape.

Lack of transparent, robust ESG data reported in a standardized manner is a fundamental impediment to accelerating investor capital allocation to sustainable assets and projects. In 2022, 42% of the FTSE All World index (about 3900 large and mid-caps globally) were still not disclosing basic Scope 1 and 2 GHG emissions. FTSE Russell's 2023 sustainable investing survey shows data availability and quality as the number one barrier to implementation of ESG considerations. The market has therefore naturally turned to estimations and assumptions to fill in this gap, in return fueling potential concerns of greenwashing depending on how rigorous those estimations were established.

Regulators have rightly sought to standardize corporate ESG reporting. The recent major steps made in the field of ESG reporting will significantly change the face of sustainable finance, starting with CSRD: our analysis showed that at least 10,300 non-EU companies will be subject to the EU ESG reporting – a third of which is located in the US. That's in addition to the 50,000 European companies.

CSRD will also improve ESG data reliability thanks to the independent audit requirement; it will increase the number of firms reporting the alignment to the EU green taxonomy; expand the scope of ESG reporting to all large non-listed companies; and make this entire dataset available free of charge on the European Single Access Point (ESAP) for anyone.

In parallel, the ISSB has worked with stakeholders across the globe to adopt climate-related standards that will serve as a global basis for ESG reporting. The European Commission and the ISSB have managed to keep differences between the ESRS and ISSB minimal. We applaud this cooperation as we absolutely need a common language to address risks that are global in nature.

The recent steps made in the field of ESG reporting will change the face of sustainable finance.

Thanks to ESG data now being regulated, we expect the sustainable finance environment to be drastically different in two years' time, and beyond. The remaining data gaps will be filled with better-quality assumptions as these will benefit from a voluminous sample of reported data, covering all sectors and geographies.

Regulators are now looking at the regulation of ESG ratings and scores providers. Even with the adoption of CSRD and ISSB's frameworks, ESG ratings are here to stay as they provide independent assessments of various ESG risks and opportunities. They could even grow further to help make sense of the mass of upcoming sustainability information.

A relatively recent sector - Refinitiv has been one of first providers of ESG scores back in 2002 - the industry has grown and diversified, measuring many different types of sustainability objectives.

Since ratings are a result of complex assessments, it is logical to ensure a high degree of transparency on the methodologies and source of data. These ratings are equally used, independently of the nature of their provider (pure players, NGOs or banks) and policy-makers should therefore adopt a same activity - same regulation logic. Such an approach will allow for the same level of quality of disclosures and governance across the industry.

At the same time, the sector is nascent, fast evolving and complex. Opinions differ and evolve. Measuring climate-related risks is changing by the day as research, standards and regulations constantly evolve – the Science Based Targets initiative (SBTi) alone has published 6 revisions or consultations on its standards in the last semester, covering sectors as critical as financial services, aviation, corporate value chains or transports.

Such complexity demands a flexible framework that allows for innovative sustainability solutions to emerge. Policymakers should refrain from imposing particular categories or interfere with methodologies. It is indeed essential to leave enough room for providers to research and refine assessments of ESG risks and impacts. Seeking to constraint a vibrant market which is built on agility, forward thinking and iterations could lead to an overall paralysis of the sustainable finance sector.

In conclusion, as the main ESG reporting standards are being adopted, policy-makers should now focus on supporting a sound implementation by corporates, as well as continue the conscientious effort to create global international alignment across regulators. Ensuring the delivery of globally reliable reported ESG data is the foundation of an effective and trustworthy sustainable finance framework.

DAVID HENRY DOYLE

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Giants or Windmills: how to tell reality from illusion in sustainable finance?

Miguel de Cervantes understood the power of illusion. In his masterpiece, Don Quixote becomes so 'immersed' in fanciful chivalric tales that he can no longer distinguish reality from illusion. As we meet in Cervantes' native Spain, let us examine how the EU sustainable finance agenda can avoid a Quixotic fate of its own by building guardrails to serve as reality checks.

The Quixotic Challenge

Don Quixote's misadventures provide a cautionary tale for sustainable finance practitioners. First, the Gentleman of La Mancha 'lost his wits' by reading too much fiction. He then embarks on an ambitious quest of 'righting every kind of wrong'. However, due to his distorted reality, the wrongs he confronts are often imaginary. Most famously, he mistakes windmills for 'monstrous giants' and charges them with his lance. When his fantasy encounters the unexpected reality of a windmill at 'full gallop', the knight ends up badly bruised.

Today, we face a Quixotic challenge in sustainable finance. Urgent (and idealistic) action is required to confront the daunting reality of climate change and biodiversity loss. However, sustainable finance is grappling with limited data, new concepts, and unfamiliar metrics. How to tell reality from illusion? Which investments are imaginary giants, and which are genuine windmills?

In addition to the Taxonomy, three guardrails can help us maintain our grip on reality as we cross this frontier. First, CSRD must be applied consistently across Member States to generate high quality data. Second, sustainability labels for financial products are needed to avoid confusing investors. Third, ESG ratings should conform to minimum standards to ensure their assessments are robust, clear, and transparent.

CSRD

The base layer of reality must be high quality assured sustainability disclosure. As ESMA's Report on Greenwashing notes the 'reversed sequencing of EU legislation – with CSRD coming into force after SFDR – has led to difficulties accessing data needed by financial market participants (FMPs)'. With CSRD now within reach its rules must be applied consistently to generate reliable data for all users. Helpfully, ESMA has identified ESG disclosure as a new Union Strategic Supervisory Priority to coordinate supervisory practice. Commission guidance to ensure proper CSRD implementation must also support this essential guardrail.

> **Don Quixote's misadventures provide a cautionary tale for sustainable finance practitioners.**

SFDR

Subjective judgement will remain a feature in identifying sustainable investments under SFDR. The Commission's Q&A confirmed that FMPs must 'carry out their own assessment for each investment and disclose their underlying assumptions'. This carries potential risks as the Commission noted that 'this policy choice gives FMPs an increased responsibility towards the investment community' and FMPs must 'exercise caution when measuring the key parameters of a 'sustainable investment''. However, the acceptable parameters are still unclear. Challenges also remain in interpreting the sustainable investment definition and Do No Significant Harm principle. Without guardrails the risk of parallel sustainability realities may increase.

The potential misuse of the SFDR as a labelling regime has also been recognised by regulators. The use of Articles 8 and 9 as shorthand for sustainability performance demonstrates a clear market appetite for product labels. Indeed, ESMA notes that the 'establishment of a reliable and well-designed labelling scheme for sustainable financial products... would be beneficial'. To avoid further confusion and to meet this market demand sustainability labels should therefore be introduced as an additional guardrail under SFDR.

ESG Ratings

Finally, ESG ratings can provide a useful reality check on sustainability performance and risks. However, these assessments must also have guardrails to ensure appropriate transparency, governance, and management of potential conflicts. Users should know what ESG ratings measure and how. Equally, it should be recognised that ESG ratings represent an opinion on reality - rather than assurance of reality - and different ESG ratings providers can measure different factors. The IOSCO recommendations for ESG ratings, including freedom from political or economic interference, should also be central to the EU's proportionate regulation of these tools.

Given the existential nature of sustainability challenges Don Quixote's quest to 'dream the impossible dream' may resonate with us. However, in confronting these challenges we must not allow the underlying facts of reality to become distorted. With clear guardrails, we can overcome the Quixotic challenge and pursue investments to bring about the transition with increasing confidence.