RISK
CONCILE

# This time it's different

## An analysis of the new regulatory ESG initiatives in Europe.

Financial regulations serve many purposes. Some create a level playing field amongst the different market-participants, others add more transparency or have a focus towards more financial stability, etc… There is one unfortunate but common denominator that marks financial regulations: all the rules get re-written and amended all the time. An example is easy to find: in 2010, risk managers, compliance officers, auditors and consultants were still busy implementing Basel II when Basel III came lurking around the corner. In some cases, long-awaited rules are postponed and pushed further along the implementation calendar[1]. And now we all have our sleeves rolled up dealing with IFRS.

In this contribution, RiskConcile provides an overview of the new upcoming EU regulations focused on climate change and illustrates the hurdles ahead for the fund management industry. The regulatory overhaul impacts entities and products. UCITS and alternative fund managers (even non-EU) will be confronted with this. Some of the proposals will even have a direct impact on the risk-return profile of financial products. Others will require more disclosures to be made. A lot of hard work, filling gaps in data, adapting risk management processes and filling out new reporting templates. Of course, with one common noble goal: stop global warming!

## Regulatory Update

### Most recent events

On April 30th, the updated ESG Disclosure rules for benchmarks became effective. This package of rules is amending the existing Benchmark Regulation (EU 2016/2011). The existing regulation has been two years in operation. This most recent amendment is the precursor of an avalanche of new rules, directives, reporting and calculation templates that are going to land on everybody's desk.

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[1] 2 year delay in the implementation of the PRIIPS-RTS for UCITS-funds.

Indeed, new climate-related prudential initiatives have been politically agreed by the European Commission in the fall of 2019 :

- the arrival of the long-awaited European Taxonomy
- the European Green bond standard
- the advent of two new climate benchmarks
- the regulation on sustainability-related-disclosure (SFDR)

Larger financial institutions have already lined-up dedicated teams to sort all of this out and bring their traders, compliance officers and IT teams up to speed on this new topic. Law firms have been sharpening their pencils and have kept their clients in the loop. This climate-change regulation will impact the way we manage and issue financial instruments and also the way we disclose our activities in this domain. The Green Deal of the European Commission, not only increases our work load. It changes fundamentally the way we work as quants, data scientists, compliance officers, investor relations and fund managers. Even after being confronted with the COVID-19 crisis, the European Commission President Ursula von der Leyen, puts the European Green Deal at the centre of the EU's recovery plan. These new climate initiatives are clearly here to stay.

## THE EU ACTION PLAN

The Paris Agreement (COP21[2]) has as objective to significantly reduce the risks and impacts of climate change. Its target is to hold the increase in the global average temperature to well below 2 °C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5 °C above pre-industrial levels. The 2 °C threshold is where many scientists see irreversible damage with extreme weather effects. After adopting the Paris Agreement and the UN 2030 Agenda for Sustainable finance, the European Commission published in March 2018 its action plan on financing sustainable growth. This EU Action plan has specified ten different outspoken actions across three different objectives. One of the Commission's objectives is " to re-orient capital flows towards more sustainable investments". It is clear that such a bold statement will impact the portfolio construction process and resulting asset allocation. Even alternative funds marketed in the European union will feel the heat. There is no regulatory arbitrage.

A direct outcome of the EU Action plan, was the creation of a Technical Expert Group. The members of this working group came from academia, the financial sector and included representatives from the EU and international bodies. Their task was to support the commission with their legislative proposals.

[2] It was the 21st yearly session of the Conference of the Parties (COP) to the 1992 United Nations Framework Convention on Climate Change.

# TAXONOMY

Going forward we will all have to come to grips with the European Taxonomy Regulation. The Taxonomy is a classification tool and is the result of the work of the EU's Technical Expert Group (TEG). The drafting of the taxonomy tool started early 2019. The main reason for the creation of this taxonomy, was the fact that the European financial industry lacked a set a of commonly agreed interpretations and application of environmental, social and governance references and definitions of what can be considered a sustainable investment. Later in the year, the Taxonomy got the political blessing of the Commission. This Taxonomy provides guidance to all financial participants assisting them in the classification of the environmental impact of a particular economic activity. An economic activity is either aligned or not aligned with the Taxonomy. Its publication is a game changer in the fight against green washing.

The Taxonomy defines six environmental objectives : i) Climate change mitigation, ii) Climate change adaptation, iii) Sustainable use and protection of marine resource, iv) Transition to a circular economy, v) Pollution prevention and vi) Protection and restoration of biodiversity and ecosystems. In order for an economic activity to aligned with the taxonomy, three conditions will have to be met:

1. The activity must make a material contribution to at least one of the six environmental objectives.
2. The activity shall not cause any substantial harm to any of other environmental objectives. This is the "Do No Significant Harm"-principle (DNSH).
3. The activity shall comply with the minimum social safeguards.

To screen a particular activity against the six environmental objectives, the Commission will deliver Delegated Acts with dedicated screening criteria. This will take place in two phases, the climate change mitigation and climate changed adaptation come first and we can expect formal criteria by the end of 2020. The other four environmental objectives will have criteria by the end of 2021. All of this is work in progress and emphasizes the dynamic character of this regulation.

Once the Taxonomy Regulation is in force and up and running, an equity fund manager will slice the portfolio into different activities. Each activity is represented by a NACE code, which has screening criteria against the environmental objectives. At the end of the exercise, the fund manager can disclose that his or her portfolio is [x]% aligned with the Taxonomy.

Note that this regulation is not a label-providing regulation. But beware, the construction of an ECO-label for financial instruments is currently being examined by the European Commission's Joint Research Centre. ECO labels are  certainly coming our way.

In the upcoming sustainability disclosure regulation, a seat on the front row has been reserved for the Taxonomy. The Taxonomy and Disclosure Regulation work in tandem, providing us a set of definitions. Whether you are managing a UCITS fund, a private equity

fund or a real estate fund, you shall disclose according to the Taxonomy. As a consequence, this will reduce ‘greenwashing’ in the financial sector and allow managers and investors who wish to pursue environmental and sustainable investment policies to align themselves.

## ESG disclosure on Benchmarks

The European benchmark regulation (BMR) of January 1, 2018 saw daylight following the Libor-scandal. Given the crucial role of benchmarks in investment management, it was necessary to prevent any possible manipulation in the construction of these indices. One of the consequences consisted in the creation of a register for benchmark administrators. An European supervised entity, is only to use these registered benchmarks. The EU’s recent increased focus on ESG and climate change in particular; imposes disclosure requirements for benchmarks regarding the underlying construction methodology and the way these reflect ESG factors. The new benchmark regulation (EU 2019/2089) came into force on April 30th, 2020.

## Creation of Climate Benchmarks

Stepping up its fight against green-washing culprits, the EU has introduced two particular climate benchmarks for corporate bond and equity indices. The Commission reaches out to the issuers of significant benchmarks to take a step in this direction and initiate several of such benchmarks on their respective platforms. The two new benchmark-types are :

- EU Climate Transition Benchmark (CTB)
- EU Paris Agreement Benchmark (PAB)

As we will in our next white-paper, the PAB-benchmark indices receive the toughest restrictions in terms of $CO_2$-emissions. We expect benchmark administrators to jump on the bandwagon and start offering climate indices, both as corporate bond or equity instruments. But any fund manager tying the fate of his or her investment fund to such a climate benchmark must understand that investing in the post-Green deal era, has an extra dimension. Instead of diving into a corporate’s balance sheet, calculating the embedded financial ratios while possibly looking for an optimal option strategy; the fund manager will now have to become a specialist in greenhouse gas accounting, climate metrics and IPCC pathways. There is a lot of ground to cover and reading material to digest.

## European Green Bond Standard

The European Green Bond Standard-proposal has the Taxonomy as its central spine and is well aligned with the ICMA Green Bond Principles. To us it seems a bit odd that Europe is launching its own green bond standard instead of endorsing an existing one. Together with the creation of an Eco label for financial instruments, this standard was one of the topics in

the EU Action plan, intended to protect the integrity and trust in a sustainable financial market.

## SFDR REGULATION

The Sustainability Financial Disclosure Regulation (EU) 2019/2088 will apply from 10 March 2021. From that moment it applies to all EU countries. The SFDR prescribes disclosures to be made by entities and financial products relating to sustainable investments and sustainability risks. The scope for the entities that fall under this regulation is broad, one could even claim that nobody is exempted: AIFMs, UCITS [3] management companies, investment firms, financial advisers, pension funds and insurance companies. The list is long and the timeline is short !

The three ESAs (ESMA,EIOPA and EBA) have been mandated to work out the regulatory technical standards on this regulation (RTS). A consultation document [4] was prepared by the ESAs through which they are seeking input from the financial industry. The final version of the RTS is foreseen on December 30th 2020. This obviously does not leave the industry with a lot of time to amend and complete prospectuses, factsheets and websites. On June 30th, 2021 financial market participants with more than 500 employees shall already publish on their websites a statement on their due diligence policies with respect to principal adverse impacts of investment decisions on sustainability factors.

The sustainability factors subject to this regulation go beyond climate change and cover the complete ESG-spectrum. In the draft-version of the disclosure templates (Annex I of the consultation document), items such as water consumption, de-forestation, etc… of the investee companies are part of the disclosure. Bribery, corruption, work-related injuries, etc… are also part of the reporting template.

The Disclosure Regulation introduces the notion of adverse impact. This is the impact of an investment decision or a financial advice that results in a negative effect on sustainability factors such as the climate, social matters, anti-bribery,…. The disclosure clearly works on two levels (entities and products) and in two directions: adverse impact and sustainability risk. Where the first illustrates how a product or an entity can for example harm the climate,

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[3] In 2019 ESMA published two final reports containing details on the integration of sustainability risks and factors, relating to ESG considerations into the Markets in Financial Instruments Directive II (MiFID II), the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings in Collective Investment in Transferable Securities (UCITS) Directive

[4] https://www.esma.europa.eu/sites/default/files/jc_2020_16_-_joint_consultation_paper_on_esg_disclosures.pdf

the second one goes in the other direction. A sustainability risk is defined as any environmental, social or governance event or condition that, if it occurs, could cause a negative material effect on the value of the investment.

The SFDR seeks to achieve more transparency from financial markets participants how sustainability risks are integrated into their investment decisions and advice. If a manager does not consider sustainability risks it needs to say why. A manager with an assessment that leads to the conclusion that those risks are relevant and could have an effect on a financial product should disclose these effects in either qualitative or quantitative terms.

### European Platform on Sustainable Finance

In the taxonomy regulation, the European Parliament and Member States agreed to create a platform on sustainable finance. It is a permanent platform which will bring together experts from the public and private sectors, including the European Environment Agency and the European Supervisory Authorities. The European platform on sustainable finance, has to keep the technical criteria in the taxonomy up to date with the fast-changing nature of science and technology. The establishment of such a platform again emphasizes the dynamic nature of the regulation. Nothing is set in stone, any criteria in the taxonomy can be up for change anytime. Financial institutions with sloppy ESG or compliance teams will create a liability for their investors.

## What's next ?

In this contribution RiskConcile has shed a light on what the European Commission has prepared and how this preparatory work will inevitably evolve into directives and regulations. In our next paper we will take a somehow more quantitative direction. ESG data and climate data are to be considered the backbone of the taxonomy, the disclosures rules and the two new climate benchmarks. Quants and data-scientists will have to re-invent themselves.