International Insight: READY, SET, GO … GREEN! The new European rules on sustainable finance are now at a starting point: first obligations from 2021

What emerges from the special report on climate change published by the Intergovernmental Panel on Climate Change (IPCC) (IPCC, 2018) is yet further confirmation of what we are all aware of: maintaining our current pace of waste and consumption is taking us perilously close to the point of no return to save planet Earth.

The Organisation for Economic Co-operation and Development (OECD) estimates that a total of US$6.9 trillion per year will be needed to achieve the objectives of the Paris Agreement on Climate Change by 2030 (OECD, 2018), which means that the solution to the climate challenge will, necessarily, pass through the economy; the financial world must develop new strategies to attract new investment.

Public and private capital must act together to finance the transition to a greener economy and to ensure the achievement of objectives in line with the UN Sustainable Development Goals (SDGs).[1]

The appetite for investing in sustainable finance is growing in both individuals and companies. The latest edition of the Eurosif Study on Sustainable Finance in Europe has shown a significant progression from 3% to over 30% for the period between 2013 and 2017 (Eurosif, 2018), while the latest Global Sustainable Investment Alliance reports that the volume of sustainable investments reached US$31 trillion in 2018 (GSIA, 2018).

The growing attention given to green issues has made banks adapt their financial offerings accordingly. The Vice-President of the European Investment Bank (EIB), Dario Scannapieco, announced in a recent interview (Capozzi, 2020) that by 2025 the EIB's commitment will be to increase by 20% the annual funding that positively impacts on climate and the environment, and to stop funding energy projects that burn standard fossil fuels. For its part, Moody's indicates that banks issued a record US$121.8 billion of green, social and sustainable bonds in 2019, which represents an increase of 41% on the previous year (Moody's, 2020), and Associazione Bancaria Italiana (ABI) recently announced that issuances in green and sustainable bonds by Italian banks have so far

[1] The SDGs are the targets for 2030 agreed by UN member states as part of the Global Agenda for Sustainable Development, approved in September 2015. There are 17 targets and they are articulated in 169 targets. The aim is to address the challenges posed by climate change and reduce all forms of poverty or inequality, ensuring the long-term economic, environmental and social sustainability of human communities. For more information, visit www.un.org.

raised more than 2 billion euros, with a clear acceleration in the two-year period 2019-2020 (ABI, 2020).

The boom in the green bond[2] market has also led to a significant growth in the issuance of this type of bond by financial institutions and companies, which amounted to around US$142 billion in 2019, with corporate issuances alone growing by 90% compared to the previous year (Stéphane Rüegg, 2020).

1. THE EU GREEN BOND STANDARD

The development of the EU Green Bond Standard (GBS) represents a crucial opportunity to increase the availability of capital necessary to fund the transition to a more sustainable economy and to achieve the international commitments undertaken by the European Union. However, while the market is growing, green bonds remain a fraction of the overall bond market (less of than 4% of the EU market as of 2019) (EC, 2020) mainly due to (a) the lack of agreement and clarity on what characterizes a "green" bond; (b) the often complex review procedures for green bonds; and (c) a lack of investable projects and assets (EC, 2020).

To address the issue, the European Commission's High-Level Expert Group on Sustainable Finance (HLEG) recommended the creation of a uniform green bond standard within the EU, which was included as Action 2 of the 2018 Action Plan on Financing Sustainable Growth and assessed by the Technical Expert Group in their final proposal for a GBS in June 2019, recently updated in March 2020 (EC, 2020).

The GBS is a system of voluntary shared criteria for the issuance of green bonds, inspired by criteria and good practices currently widespread in the market, such as the Green Bond Principles – GBP (ICMA, 2018).

The "EU Green Bond" certification will be attributed to any type of bond or debt instrument, whether listed or unlisted, issued by a European or international operator which is GBS-compliant (Commission, 2019). This means that

- the bond will have to be aligned with the taxonomy on eco-friendly activities – to identify projects and activities that can be financed;
- a Green Bond Framework (GBF) will have to be published, i.e., a document in which the issuer will affirm its willingness to align with the GBS, the compliance of the financing plan with the EU environmental objectives, the key aspects of the use of proceeds and investment processes; and

[2] Green bonds are debt securities associated with the financing of projects in sectors that have positive effects in environmental terms, such as renewable energy, sustainable management of waste and water resources, protection of biodiversity, and energy efficiency (Borsa, 2020).

- an annual report on the allocation of proceeds and the environmental impact generated will be produced. In addition, an external auditor – subject to the accreditation and the supervision of the European Securities and Markets Authority (ESMA) – will verify compliance with the GBF and the proper allocation of proceeds (FIS, 2019).

In line with this, the European Commission is expected to publish a new Regulation on the GBS in the first quarter of 2021.

2. THE EUROPEAN ACTION PLAN

What does "sustainable" really mean in the context of finance? Under what conditions can an investment be considered sustainable? Which economic activities can be considered "green" and which criteria should be applied?

Since "green" can come in many shades, investors struggle to evaluate the truthfulness of the ethical and sustainability claims related to green investments, while issuers risk being accused of "greenwashing" (discussed in Curtis' Client Alert 19 November 2020).[3]

The European Union has tried to address the issue, and so far has launched several initiatives aimed at ensuring greater transparency, coherence and clarity with regard to the so-called "green economy."

With the signing of the Paris Agreement on Climate Change[4] in 2016, the Union committed itself to promoting a transition towards more sustainable economic models. In December of that year, the commitment was translated into concrete terms, with the establishment of the HLEG, which was tasked by the European Commission with formulating recommendations to build a sustainable finance framework.

On this basis, the European Commission published in March 2018 the Action Plan on Financing Sustainable Growth (EC, 2018), with the aim of providing a common approach to sustainability to ensure that financial operators have precise criteria for

[3] NN Investment Partners warns that about 15% of emissions come from companies involved in controversial practices that contravene environmental standards, while only about 85% of green bonds deserve the ESG label, as the rest are issued by companies that, despite using funds for sustainable projects, are still involved in activities that have negative impacts elsewhere (Valentini, 2020).

[4] The Paris Agreement is an international treaty signed by 195 States at COP21, the twenty-first annual meeting of the Conference of the Parties to the United Nations Framework Convention on Climate Change, held in Paris on 12 December 2015. The main commitment of the signatory states is to limit the increase in global temperatures to well below 2 degrees Celsius (°C) compared to pre-industrial levels, and to do everything possible to limit the increase to 1.5 degrees Celsius (°C). For more information, visit www.ec.europa.eu.

defining, measuring and communicating the sustainable characteristics of their economic activities.

2.1 Harmonizing Transparency Rules for Financial Markets – Regulation (EU) 2019/2088

In December 2019, the European Commission published Regulation (EU) 2019/2088 on Sustainable Finance Disclosure (SFDR).

The SFDR establishes harmonized transparency rules for financial market participants and financial advisors; in particular: "*requires financial market participants and financial advisors providing investment or insurance advice on insurance investment products (IBIPs), irrespective of the design of the financial products and the reference market, to publish written policies on the integration of sustainability risks and to ensure the transparency of such integration*" (Recital 13 of Regulation (EU) 2019/2088).

This means that financial operators will be required to publish on their websites information about how they integrate sustainability risks[5] into their investment decision-making processes. If these risks could affect the performance of the financial product, they will be required to communicate to what extent, in quantitative and qualitative terms, they could negatively affect sustainability factors.[6]

In terms of information required, financial advisors will have to disclose how they have taken into account sustainability risks and environmental, social and governance (ESG) factors in the selection and choice of the financial product; and explain the negative effects on sustainability factors in their ongoing periodic reports (Abate & Travanini, 2020).

This standardized product certification should enable investors to better understand the level of sustainability of their investments.[7]

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[5] Article 2, par. I, no. (22) of Regulation (UE) 2019/2088 defines "sustainability risk" as "an environmental, social or governance event or condition that, if occurs, could cause an actual or a potential material negative impact on the value of the investment."

[6] Article 2, par. I, no. (24) of Regulation (UE) 2019/2088 defines "sustainability factors" as "environmental, social and employee matters, respect for human-rights, anti-corruption and anti-bribery matters."

[7] Article 2, par. I, no. (17) of Regulation (UE) 2019/2088 defines "sustainable investment" as an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a

Even though the SFDR will enter into force on 10 March 2021, professionals have already expressed concerns on the difficulty of collecting the data required by the legislation (such as water emissions, emissions of ozone-depleting substances, company policies on trafficking in human beings) and the costs this will entail (Tramonto, 2020).

2.2 A Taxonomy of Sustainable Finance – Regulation (EU) 2020/852

Among the priorities identified in the Action Plan is a new European "taxonomy" for sustainable finance, i.e., a shared system of definition and classification of sustainable economic activities (EC, 2018).

The Regulation (EU) 2020/852 of the European Parliament and the Council of 18 June 2020, on the establishment of a framework to facilitate sustainable investment, and the amending Regulation (EU) 2019/2088, set out criteria for determining whether specific economic activities contribute to the achievement of six environmental objectives, namely: climate change mitigation; adaptation to climate change; sustainable use and protection of water and marine resources; transition to a circular economy, referring to waste reduction and recycling as well; pollution prevention and control; protection of biodiversity and the health of eco-systems (the "Objectives").

In order to be eco-compatible, economic activities shall: (i) substantially contribute to the achievement of at least one of the Objectives; (ii) not cause significant damage to any of the Objectives; (iii) be carried out in compliance with minimum social safeguards; and (iv) comply with technical criteria.

The Taxonomy Regulation provides for deferred application to 1 January 2022 and 1 January 2023, when the European Commission, supported by the Platform on Sustainable Finance, will adopt delegated acts to define the technical criteria for the selection of activities to be considered sustainable.[8]

From that time on, asset managers and other professional investors will have to disclose the proportion of investments that are compatible with the finance taxonomy for each relevant financial product, including investment funds.

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social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

[8] In particular, pursuant to Article 27(2) of Regulation (EU) 2020/852: "Articles 4, 5, 6 and 7 and Article 8(1), (2) and (3) shall apply: (a) in relation to the environmental objectives set out in Article 9(a) and (b) as from 1 January 2022; and (b) in relation to the environmental objectives set out in Article 9(c) to (f) as from 1 January 2023."

Timing is tight and many points remain to be clarified. The sustainability of investments must take into account social factors, and criteria will need to be developed to determine which activities are harmful to the environment (the so-called “brown” ones). Clarification is also needed on nuclear power, where the weight of the interests of the single Member States will be the tiebreaker (Tramonto, 2020).

2.3 Non-Financial Reporting (NFRD) – Directive 2014/95/EU

The strategy to strengthen the European framework for sustainable investment also includes the revision of Directive 2014/95/EU on Non-Financial Reporting. The NFRD provides for more stringent and standardized requirements on how companies communicate non-financial information and disclose ESG data.

Since 2018, large public-interest companies with more than 500 employees –including banks and insurance companies– have been required to add non-financial information on environmental, social and personnel issues, human rights, and active and passive corruption, into their annual financial statements (Giustiniani & Iussig, 2020).

In December 2019 the Commission announced the review of the NFRD and opened a public consultation, which ended in June 2020.[9]

3. CONCLUSIONS

If the European Action Plan succeeds in ensuring a secure, transparent and effective regulatory framework, sustainable bonds could play a key role in the transition towards the achievement of the European environmental objectives.

Given the complexities of a subject still in the making, investors and financial operators will need to take a careful and analytical approach in managing their financially sustainable choices.

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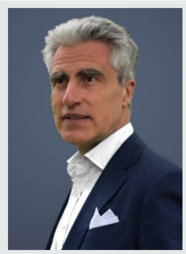

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