Frankfurt School of Finance & Management

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ISSUERS' SUSTAINABILITY REPORTING STANDARDS

EBI'S ACADEMIC CONFERENCE 9TH NOVEMBER 2022 – PROF. DR. EDGAR LÖW

Agenda

- Introduction
- Different initiatives
- Look insight
- Final remarks

Agenda

Introduction

Introduction

Background

The role of sustainability and its social and environmental dimension is recognised in the Treaty on European Union and the Treaty on the Functioning of the European Union (TFEU)

- The necessary mobilisation of capital is prevented by existing information asymmetries, as investors cannot inform themselves sufficiently about the sustainability of their investments
- The obligation to include sustainability risks and impacts in disclosure and management is essential
- In this context, the concept of sustainability is represented by the sub-categories
    - Corporate Social Responsibility (CSR)
    - Environmental Social Governance (ESG)
    - Sustainable Finance

Introduction

Terminology

Economic responsibility as a cornerstone – overlapping terminology

- In its Green Paper "Framework for Corporate Social Responsibility", the EU describes *CSR*
  - “as a business concept according to which, in addition to the goal of profit maximisation, a positive contribution is made to society in the form of social and environmental concerns that go beyond the legal requirements”
- In contrast to CSR, *ESG* explicitly mentions the governance component
- *Sustainable Finance* describes the process of considering ESG when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities

Agenda

Different initiatives

Different initiatives

Starting point – Action Plan (March 2018)

Action Plan on Financing Sustainable Growth

- Developed in 2018 as a strategic orientation in the field of Sustainable Finance and as a roadmap for future action
- Financial system to be redesigned in such a way that private capital can be redirected towards more sustainable investments
- Prerequisite for the implementation of the goals of the UN Agenda 2030 and the Paris Climate Agreement
- Definition of three concrete goals
    - Redirecting capital flows into sustainable investments
    - Inclusion of sustainability in risk management
    - Transparency regarding sustainability factors in disclosure

Different initiatives

Subsequent development – EU Commission

EU Commission has since proposed two regulations and two directives that are essential for the regulation of sustainability in the financial sector and the real economy

- Regulation (EU) 2020/852 (Taxonomy Regulation)
- Regulation (EU) 2019/2088 (Disclosure Regulation/SFDR)
- Directive COM(2021) 189 final (CSRD)
- Directive COM(2022) 71 final (CSDD)

Different initiatives

Subsequent development – EBA

The EBA is empowered to issue guidelines and recommendations for the financial institutions of the European legal area

- In the area of ESG, it does so based on several mandates (e.g. the EU Action Plan and the Capital Requirements Regulation (CRR II) and Directive (CRD V))
- For this purpose, the EBA has created its action plan on sustainable finance, which describes and announces measures in the areas of strategy and risk management, as well as disclosure
- These include
  - Guideline on Lending (EBA/GL/2020/06)
  - Standard on ESG Risk Disclosure (EBA/IST/2022/01)
  - Report on ESG Risk Management and Supervision (EBA/REP/2021/18)

Different initiatives

Subsequent development – EFRAG

The European Financial Reporting Advisory Group (EFRAG) advises the European Commission in certain areas and has received a specific mandate for ESG to develop new standards

- European disclosure standards to be issued with recourse to the draft work of the EFRAG
    - On 29 April 2022, EFRAG published the first drafts of European Sustainability Reporting Standards (ESRS) for which consultation was held until 08 August 2022
    - Final drafts are to be submitted to the European Commission on 15 November after analysis of the feedback received (they are based on the fundamental requirements of the CSRD proposal)

Different initiatives

Subsequent development – IFRS-Foundation (ISSB)

International Accounting Standards Board (IASB) and International Sustainability Standards Board (ISSB)

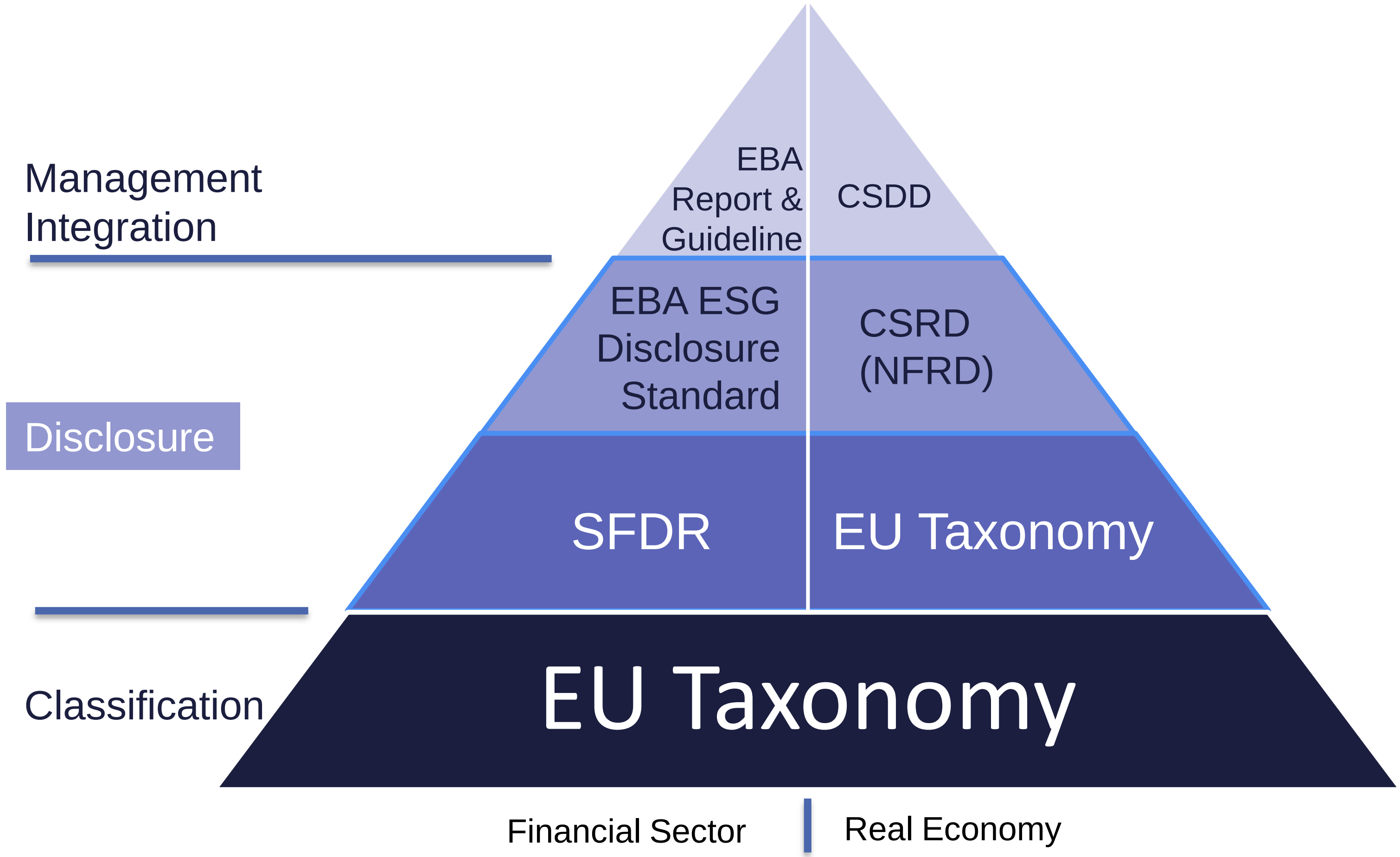
- For European companies that have to keep their accounts by international standards, the requirements of the International Financial Reporting Standards (IFRS) apply
- In response to the increasing demand for sustainability information, the IFRS-Foundation has established a group of experts, the International Sustainability Standards Board (ISSB), to develop a regulatory framework for sustainability reporting that can be applied on a global basis
- The ISSB has published two exposure drafts that are to supplement the IFRS in the future
- Both drafts deal with the disclosure of sustainability-related financial information
    - The first draft (ED/2022/S1) defines general requirements
    - The second draft (ED2022/S2) focuses on climate-related disclosures

Different initiatives

ESG initiatives by issuing authority

- EU
  - EU Commission (EU Action Plan)
    - Taxonomy Regulation
    - Sustainable Finance Disclosure Regulation (SFDR)
    - Corporate Sustainability Reporting Directive (CSRD)
      - European Sustainability Reporting Standard (ESRS) 1
      - European Sustainability Reporting Standard (ESRS) 2
    - Corporate Sustainability Due Diligence (CSDD)
  - EBA (EBA Action Plan)
    - Guideline on Lending (EBA/GL/2020/06)
    - Standard on ESG Risk Disclosure (EBA/IST/2022/01)
    - Report on ESG Risk Management and Supervision (EBA/REP/2021/18)
- IFRS
  - International Sustainability Standards Board (ISSB)
    - Exposure Draft 1
    - Exposure Draft 2

EU – ESG initiatives



Agenda

Look insight

Look insight

EU Taxonomy Regulation (1)

The EU Taxonomy Regulation serves as the basis for the creation of a substantial part of the further ESG-related initiatives at the Union level, which determines using a classification system which economic activities are to be considered environmentally sustainable (Art. 1)

- It addresses financial market participants offering financial products as well as companies that are obliged to publish a non-financial statement (Art. 1)
- It defines an economic activity according to Art. 2 No. 1 in conjunction with Art. 3a) as environmentally sustainable if it makes a significant contribution to the realisation of one or more of the environmental goals listed in Art. 9
- It eliminates the asymmetry of information between investors and financial market participants about sustainability-related information – several disclosure regulations have been initiated at the EU level with the intention to make the information missing for sustainable investment decisions accessible to investors

Look insight

EU Taxonomy Regulation (2)

- Outside of the Disclosure Regulation (see next slides), the Taxonomy Regulation only has legal consequences through Art. 8 in the form of disclosure obligations for companies in the real economy that are obliged to make non-financial disclosures under the CSR Directive (2013/34/EU) – for banks on their reporting on Art. 8, see EBA
- The reporting obligation from the NFRD (CSR Directive) is thereby extended in the taxonomy about the publication of "taxonomy quotas" concerning the percentage of
  - Ecologically sustainable share of sales revenues (illustrates the degree of sustainability of current economic activities)
  - Investments (illustrates the future proportional sustainability development)
  - Operating expenses (if applicable)

Look insight

Sustainable Finance Disclosure Regulation (SFDR) (1)

Regulation (EU) 2019/2088 on sustainability-related disclosure requirements (Disclosure Regulation) was adopted for the financial services sector

- Addresses financial market participants and financial advisors and obliges them to disclose information on sustainability risks and adverse sustainability impacts in investment decisions and financial products (Art. 1)
  - Sustainability risks refer to potential impairment of the value of the investment due to an environmental, social or governance event or condition
  - Adverse sustainability impact refers to damage to sustainability factors (i.e. environmental, social and labour concerns, respect for human rights and the fight against corruption and bribery)
- Disclosure takes place on the one hand from the "outside-in" perspective (influence of external factors on a company) and on the other hand from the "inside-out" perspective (influence of the company on external factors)

Look insight

Sustainable Finance Disclosure Regulation (SFDR) (2)

- Disclosure requirements
  - Company-related requirements
  - Product-related obligations
- About the company, the addressees have to transparently present their strategy regarding the inclusion of sustainability risks in their investment or investment advisory process on their website (Art. 3)
- The product-related transparency obligations are primarily to be fulfilled via pre-contractual information to clients
  - Depending on the type of financial product, a pre-contractual information document is specified (Art. 6 para. 3)
- Financial market participants or advisors have to inform their clients how sustainability risks will be included in their future investment decisions or advice and how the expected impact of sustainability risks on returns will be assessed or explain succinctly why sustainability risks are not relevant (Art. 6)

Look insight

EBA Standard on Transition and Physical Risks of Climate Change (1)

On 24 January 2022, the EBA published its final draft for binding standards on ESG risk disclosure (EBA/IST/2022/01) based on Article 434a of the Capital Requirements Regulation (CRR - Regulation (EU) 2019/876)

- CRR requires disclosures in Part 8 (in particular Article 449a) and mandates the EBA to draft uniform disclosure formats in the form of implementing technical standards
- Uniform formats have to convey sufficiently comprehensive and comparable information to enable users of this information to assess the risk profiles of institutions
- In developing the standards, the EBA draws on the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (FSB-TCFD), the Commission's non-binding guidelines on climate change reporting and the EU Taxonomy
- Objective is to establish a single, comprehensive framework for the relevant ESG disclosure requirements arising from the Capital Requirements Regulation

Look insight

EBA Standard on Transition and Physical Risks of Climate Change (2)

EBA Implementing Standards on prudential disclosures on ESG risks

Interrelation

EBA Advice to the Commission on KPIs and methodology for disclosures under Article 8 of the Taxonomy Regulation

Relevant synergies between both mandats and commonalities regarding the information to be delivered

Look insight

EBA – ESG Disclosures Pillar 3 (1)

	WHAT TO DISCLOSE?	EXAMPLES OF DISCLOSURES
RISK DISCLOSURES	CLIMATE CHANGE TRANSITION RISK Information **on exposures** to sectors or assets that may highly contribute to climate change	▸ Exposures to fossil fuel companies excluded from sustainable climate benchmarks, and to other carbon-related sectors ▸ For real estate exposures, distribution of the exposures by energy performance of the collateral
	CLIMATE CHANGE PHYSICAL RISK Risk exposures subject to extreme weather events (sector/geography)	▸ Assets subject to impact from chronic climate change events by sector and geography ▸ Assets subject to impact from acute climate change events by sector and geography
MITIGATING ACTIONS	Actions that support counterparties in the **transition** to a carbon neutral economy but that do not meet taxonomy criteria	▸ Building renovation loans that improve the energy efficiency of the building but do not meet the taxonomy screening criteria
	Actions that support counterparties in the **adaptation** to climate change but that do not meet taxonomy criteria	▸ Loans to build barriers against flooding, or water management mechanisms against draughts but to not meet the taxonomy screening criteria

Look insight

EBA – ESG Disclosures Pillar 3 (2)

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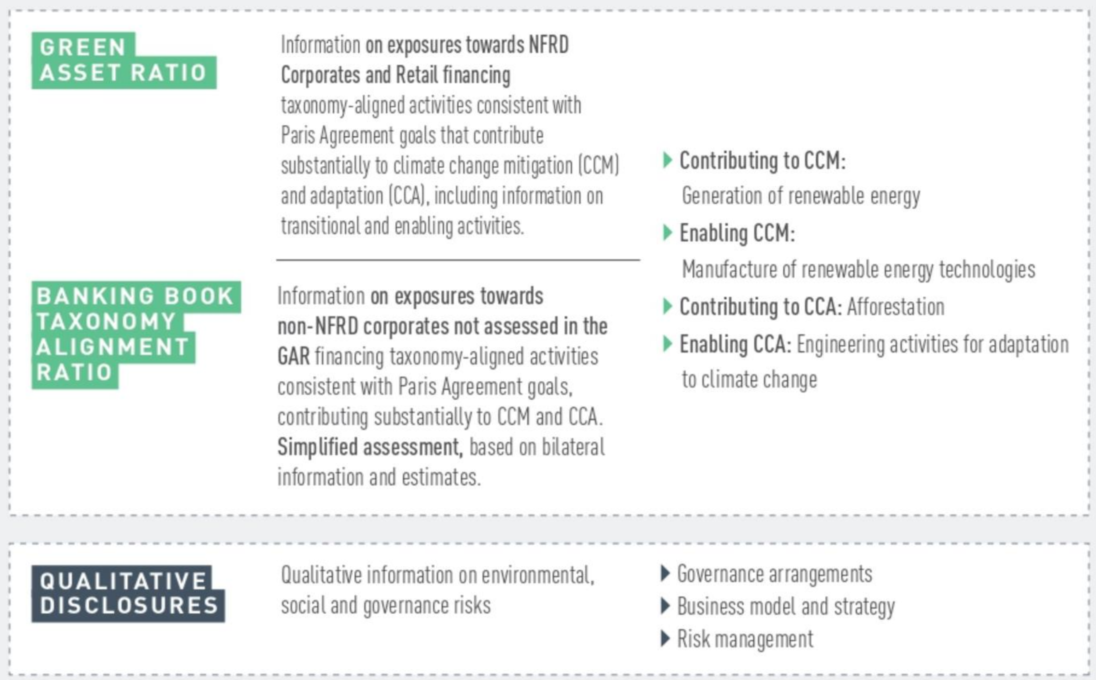
- Represents the proportion of a credit institution's assets that are invested in taxonomy-compliant environmentally sustainable economic activities that fall under the reporting requirements of the CSR Directive and that make a significant contribution to climate change mitigation and adaptation



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- Represents the same ratio for Taxonomy-compliant economic activities that do not fall under the reporting obligation of the CSR Directive

Look insight

Corporate Sustainability Reporting Directive (CSRD) (1)

European Commission proposed a directive (2021/0104(COD)) on 21 April 2021 to amend the existing directives about sustainability reporting by companies (following the Non Financial Reporting Directive – NFRD)

- Group of addressees will be expanded fourfold (approx. 49,000 companies) compared to the NFRD
- According to Art. 1 No. 4, new European disclosure standards are to be issued in the form of delegated acts with recourse to the draft work of the European Financial Reporting Advisory Group (EFRAG)
- Standards specify the information that has to be disclosed
  - on environmental factors
  - on social factors
  - on governance factors

Look insight

Corporate Sustainability Reporting Directive (CSRD) (2)

- The EU Commission justifies the standards with the necessity of a specifically European overall standards framework, above all to cover the information needs arising from the Disclosure and Taxonomy Regulation
- The statutory auditor is obliged to audit the sustainability reporting in the management report (Art. 1 No. 3 (1)) (Art. 3 Para. 1)
- On 29 April 2022, EFRAG published the first drafts of European Sustainability Reporting Standards (ESRS) for which consultation was held until 08 August 2022
- Final drafts are to be submitted to the European Commission on 15 November after analysis of the feedback received
- Standards are based on the fundamental requirements of the CSRD proposal

Look insight

EFRAG – European Sustainability Reporting Standards

Overall architecture of EDs on European Sustainability Reporting Standards aimed to be designed to ensure that sustainability information is reported in a carefully articulated manner

	Total number of DR per ED
ESRS 1 – General principles	0
ESRS 2 – General, strategy, governance and materiality assessment	22
Total General	**22**

	Total number of DR per ED
ESRS E1 – Climate change	17
ESRS E2 – Pollution	7
ESRS E3 – Water and marine resources	7
ESRS E4 – Biodiversity and ecosystems	10
ESRS E5 – Resource use and circular economy	9
Total Environment	**51**

	Total number of DR per ED
ESRS S1 – Own workforce	26
ESRS S2 – Workers in the value chain	6
ESRS S3 – Affected Communities	6
ESRS S4 – Consumers and end-users	6
Total Social	**44**

	Total number of DR per ED
ESRS G1	10
ESRS G2	10
Total Governance	**20**

About 750 Comment Letters

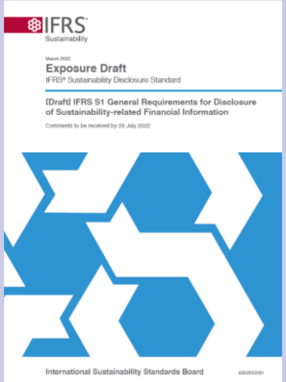
- Remarks about the volume/scope and the granularity
- Need for synchronisation with the CSRD
- Need for coordination with the ISSB
- Need for conceptual clarifications

Look insight

International Sustainability Standards Board (ISSB) (1)

The ISSB has published two exposure drafts that are to supplement the IFRS in the future

- The draft standards will be mandatory for all companies that prepare their accounts by IFRS once they have been adopted, which is planned for the end of 2022 (end enforced by the EU)



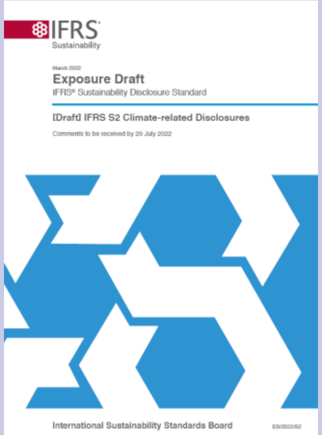
IFRS S 1 (Draft)

- General Requirements for Disclosure of Sustainability-related Financial Information

- The first draft on the basic requirements for sustainability reporting requires disclosure
  - of information on the governance of sustainability risks and opportunities
  - the related short-, medium- and long-term strategy
  - how the risks and opportunities are identified, assessed and addressed within risk management
  - on key performance indicators and targets for monitoring the company's long-term performance regarding these risks and opportunities

Look insight

International Sustainability Standards Board (ISSB) (2)



IFRS S 2 (Draft)

- Climate-related Disclosures

- The second draft
  - deals with climate-related transparency
  - aims to disclose the physical and transition risks that arise from climate change or the transformation to a more sustainable economy
  - climate-related opportunities of the company are also to be taken into account

- The drafts also refer to the industry-based standards of the Sustainable Accounting Standards Board (SASB) and to the non-mandatory guidelines of the ISSB (e.g. the CDSB Framework), which should guide companies concerned

Agenda

Final remarks

Final remarks

Disclosure requirements – open issues

- Aligning and integrating ESG-related information requirements necessary – too many disclosure requirements from too many initiatives to be fulfilled at the same time (also confusing addresses) – quantity versus quality?
- Overlapping information – conceptual/theoretical concepts in the development of disclosure requirements?
- Challenges in reliability, consistency and comparability of ESG information – over time, between companies?
- Data availability and granularity, to be questioned – auditable? Cost versus benefit?
- Conformity of ESG-related information and disclosures with the company´s ESG commitments, targets and strategic decisions – which underlying documents are to be expected (information to top management)?
- Avoidance of green-washing – responsibility for “wrong” information by the investee?
- Enforcement – ESMA, for banks ECB, both, others, more?

Thank you for your kind attention

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