POLITICAL INTELLIGENCE

Update on EU ESG policies

By Igor Kostadinovski

Contents

- Introduction
- Corporate Sustainability Reporting Directive
- Corporate Sustainability Due Diligence
- Sustainable Finance
- The EU Taxonomy
- Next Steps

Introduction

In late November 2022 European Union member states signed off on new rules that will require thousands of large companies operating in the bloc to publish more detailed information on sustainability matters than ever before. The passage of the so-called Corporate Sustainability Reporting Directive marked a milestone in the EU's efforts to make Europe's economy more environmentally friendly, support its drive to net zero, and respond to the growing importance of Environmental, Social and Governance (ESG) standards for investors.

Although the European Commission has signalled it is not planning any major new proposals in this policy area before the current European parliamentary term ends in 2024, there is nevertheless much more work to be done. European lawmakers are making progress on regulations to ensure large companies operating in the EU respect human rights and the environment in their supply chains, the so-called Corporate Sustainability Due Diligence. And work is ongoing on several fronts to develop more sustainable financial system, including the EU's so-called taxonomy regulation, disclosure rules and green bonds.

This Dods Political Intelligence report provides an update on three key areas in this policy area—the Corporate Sustainability Reporting Directive, Corporate Sustainability Due Diligence, and Sustainable Finance—setting out what has been achieved so far, and what is in the pipeline in terms of process and delivery.

Corporate Sustainability Reporting Directive

The Council formally adopted the Corporate Sustainability Reporting Directive (CSRD) on November 28, 2022. The regulation requires large EU companies, whether listed on stock markets or not, to publish information on the social and environmental impacts of their activities and how external sustainability factors such as climate change or human right issues influence their activities. Non-EU companies with a turnover over €150 million in the bloc will also have to comply, while listed small and medium-sized firms will be covered but have more time to adapt to the new rules. The EU has estimated its rules on non-financial reporting apply to approximately 11,700 large companies and groups across the EU, including listed companies, banks, insurance companies, and other firms designated public-interest entities.

"The new rules will make more businesses accountable for their impact on society and will guide them towards an economy that benefits people and the environment," Jozef Síkela, the Czech Minister for Industry and Trade, said in a statement on the day the regulation was adopted.

The new rules will:

- require, for the first time, a general EU-wide audit (assurance) requirement for reported sustainability information ("limited' assurance" as opposed to a more demanding "reasonable assurance").
- introduce more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards set by the Commission on the advice of the European Financial Reporting Advisory Group (EFRAG).
- require companies to prepare financial statements and management reports in XHTML format in accordance with the European Single Electronic Format Regulation and to digitally "tag" the reported information so it is machine readable and feeds into the European single access point envisaged in the Capital Markets Union Action Plan.

In terms of delivery, member states will be expected to incorporate the new rules within 18 months, in time for them to meet the following rollout schedule:

- From 1 January 2024 for large public-interest companies (with over 500 employees) already subject to the non-financial reporting directive, with reports due in 2025.
- From 1 January 2025 for large companies that are not presently subject to the non-financial reporting directive (with more than 250 employees and/or €40 million in turnover and/or €20 million in total assets), with reports due in 2026.
- From 1 January 2026 for listed SMEs and other undertakings, with reports due in 2027. SMEs can opt-out until 2028.

EFRAG has been developing the standards in parallel to the legislative work and published the first draft European Sustainability Reporting Standards (ESRS) on November 23, 2022. The Commission is due to consult EU member states and a range of European authorities, such as the European Environment Agency and the European Central Bank, on the draft with a view to adopting the final standards by delegated acts by June 2023, followed by a scrutiny period by the European Parliament and Council.

EFRAG has also begun work on a second set of more sector-specific draft ESRS that should also include standards for SMEs which it aims to submit to the Commission by autumn 2023. These will cover five sectors covered by GRI: agriculture, coal mining, mining, oil + gas (upstream), oil + gas (mid-to downstream); and five high-impact sectors: energy production, road transport, motor vehicle production, food/beverages, and textiles.

Corporate Sustainability Due Diligence

In February, 2022, the European Commission set out plans for new rules to ensure large companies operating in the EU respect human rights and the environment in their global value chains. The Directive on corporate sustainability due diligence would require companies to identify, prevent, or mitigate any adverse actions by their suppliers around the world, for example on the use of child and forced labour, or pollution and biodiversity loss.

The directive has proved controversial. While Didier Reynders, the Commissioner for Justice, said the rules will help support human rights and the green transition, some business groups argued that it was unrealistic to expect companies to police their global supply chains while environmental groups said the rules did not go far enough.

The Commission's proposal would require the companies within its scope to integrate due diligence into their policies; identify actual or potential adverse human rights and environmental impacts and subsequently prevent, mitigate, end or minimise them; establish and maintain a complaints procedure; monitor the effectiveness of the due diligence policy and measures; and publicly communicate on due diligence. The adverse environmental and human rights impacts covered by the proposal are specified in an Annex. In addition, some large companies would be required to have a plan to ensure their business strategy is compatible with limiting additional global warming to 1.5 C in line with the Paris Agreement.

In terms of the scope, the new due diligence rules will apply to the following companies and sectors:

- EU companies:
    - Group 1: all EU limited liability companies with 500+ employees and EUR 150 million+ in net turnover worldwide. The Commission estimates there are about 9,400 companies in this group.
    - Group 2: Other limited liability companies operating in defined high impact sectors (e.g. textiles, agriculture, extraction of minerals), which do not meet the Group 1 thresholds, but have more than 250 employees and a net turnover of EUR 40 million worldwide. For these companies, rules will start to apply two years later than for group 1. The Commission estimates there are about 3,400 companies in this group.
- Non-EU companies with turnover generated within the EU that meet the threshold of Group 1 and Group 2. The Commission estimates, this would affect around 2,600 companies in Group 1 and around 1,400 in Group 2.

The directive also introduces duties for the directors of the EU companies that it covers. These include setting up and overseeing the implementation of the due diligence processes and integrating due diligence into the corporate strategy, and the human rights, climate and environmental consequences of their decisions. While SMEs do not fall directly within the scope of the proposal, it foresees support for smaller firms that might be affected indirectly, including guidance and other tools to help them integrate sustainability considerations in their operations.

The directive stipulates that national authorities would be responsible for ensuring the new rules are followed and imposing fines in case of non-compliance, while the rules for directors' duties should be enforced through existing national laws. The directive would also require member states to adapt their rules on civil liability to cover cases where damage results from failure by a company to comply with due diligence obligations. Once adopted, member states will have two years to transpose the directive into national law.

Legislative progress

There has been significant legislative movement on the directive in recent weeks. At the time of writing, the Council had agreed its general approach to the directive, paving the way for trilogue negotiations to start once the Parliament has adopted its position in a plenary expected May 2023.

In the Parliament, the Legal Affairs Committee (JURI), which is responsible for the file, published a Draft report on the proposal on November 8. The rapporteur, Dutch MEP Lara Wolters, from the Progressive Alliance of Socialists and Democrats, said she wanted companies to proactively identify and address risks throughout their entire value chain, although the draft report said they should be liable "only where they actively cause or contribute to harm". She also said companies should be able to prioritise the most severe problems in their value chains and removed the concept of "established business relationships". The rapporteur also proposed adding two new articles to ensure companies remedy harm and follow a more thorough and systematic consultation of stakeholders. Wolters also suggested support measures and changes to contracts to prevent companies passing on the burden to small suppliers but said high-risk and listed SMEs should be included in the new rules.

A JURI Committee debate on the draft report on November 17 revealed mixed views on the scope of the directive. Adrián Vázquez Lázara, chair of the committee and Spanish member of the liberal Renew Europe Group, said that "while the inclusion of SMEs could be a possibility in the future, this can only be done when they have tested such an ambitious piece of legislation on very large companies first". Gilles Lebreton, a French far right MEP from the Identity and Democracy Group, said they should "start with a more cautious text, apply it to larger companies only, and see what happens". However, Heidi Hautala, Finish MEP from the Greens/European Free Alliance, said "whether they like it or not, [SMEs] will at least be indirectly impacted," and argued that "It is useful to include all enterprises in the approach, with the exception of micro-enterprises." In terms of the next steps, MEPs are due to consider amendments to the draft report in January 2023, followed by a committee vote in March before the report goes before plenary in May.

The Council has made faster progress. It adopted a general approach for the institutional talks with the Parliament on December 1. It has proposed several amendments to the Commission proposal, including a shift to a more risk-based approach and a different compliance timeline. The Council said it wanted the rules to apply first to EU companies that have more than 1000 employees and €300 million net worldwide turnover, and for non-EU companies with €300 million net turnover generated in the EU, three years from the entry into force of the directive. The Council has also proposed the introduction of the concept of a company's 'chain of activities', which would effectively remove the concept of company responsibility for the post-sale use of their products or services from the scope of the rules.

The debate leading up to the adoption of the Council's general approach revealed different views on some key issues, including on the inclusion of financial services which was eventually left for member states to decide for themselves. Some member states, such as the Netherlands, Denmark, Ireland and Finland, warned that this could lead to fragmentation of the single market and called for a sunset clause on this issue. They called for a more ambitious approach and for the entire value chain to be covered. Other member states, such as Sweden, Hungary and Poland, spoke of the need to ensure companies were not overburdened and remained competitive.

Sustainable Finance

The Commission has also continued its work on a package of measures published in July 2021 to make the EU's financial system more sustainable. These include the Sustainable Finance Strategy, a proposal for a European Green Bond Standard, and a delegated act supplementing Article 8 of the Taxonomy Regulation.

The **Sustainable Finance Strategy** set out six ambitions with numerous actions to achieve them (full list in the annex to the Communication):

- Develop a more comprehensive framework and help the financing of intermediary steps towards sustainability.
- Improve the inclusiveness of sustainable finance.
- Enhance economic and financial resilience to sustainability risks.
- Increase the contribution of the financial sector to sustainability.
- Monitor an orderly transition and ensure the integrity of the EU financial system.
- Set a high level of ambition in developing international sustainable finance initiatives and standards and to support EU partner countries.

The focus of the strategy was on the implementation and development of secondary legislation to carry through previous work is this area. As such, much of this work has been done in cooperation with the European Supervisory Authorities (ESAs) (the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), and European Securities and Markets Authority (ESMA)) and its primary impact has been on the financial sector. However, the overarching ambition remains finding a way to open opportunities for financing a sustainable transition across the economy as a whole. The Commission said it would report on the implementation of the strategy by the end of 2023 and support member states in their efforts on sustainable finance.

The Commission's proposed European Green Bond Standard **(EU GBS)** aims to create a voluntary "gold standard" for all issuers to help finance sustainable investments. The EU GBS proposal, which has been submitted to the European Parliament and Council as part of the co-legislative procedure, comprises four key requirements:

- **Taxonomy-alignment**: The funds raised by the bond should be allocated fully to projects that are aligned with the EU taxonomy.
- **Transparency**: There must be full transparency on how bond proceeds are allocated through detailed reporting requirements.
- **External review**: All European green bonds must be checked by an external reviewer to ensure compliance with the Regulation and taxonomy alignment of the funded projects. The Commission specifies that a specific, limited flexibility is foreseen here for sovereign issuers.

- Supervision by reviewers registered by ESMA: External reviewers providing services to issuers of European green bonds must be registered with and supervised by ESMA.

A fourth, and potentially final, trilogue to discuss the green bond standard has been scheduled for December 14, 2022. Previous trilogues took place on July 12, October 18 and November 16. The Council agreed its position in April, Parliament approved its negotiating position the following month, and then a document comparing the views of the co-legislators was published in June. .

At an ECOFIN meeting on November 8, Mairead McGuiness, Commissioner for Financial Services, Financial Stability, and Capital Markets Union, took note of the progress achieved, adding that the Commission would continue facilitating discussions between the co-legislators on some key aspects, like the liability regime and options to foster greener securitization. Zbyněk Stanjura, the Czech Minister for Finance, said he believed it would be possible to reach a political agreement on the file by the end of the year.

The EU Taxonomy

The Commission has published a number of delegated acts to develop the Taxonomy Regulation since the rules determining whether an economic activity is environmentally sustainable entered into force in July 2020. This has included the delegated act supplementing Article 8 of the regulation which specifies the content, methodology and presentation of information to be disclosed by financial and non-financial actors and entered into force at the start of 2022.

Financial institutions, which include large banks, asset managers, investment firms and insurance/reinsurance companies, are required to disclose the share of environmentally sustainable economic activities in the total assets they finance or invest in. Non-financial companies have to disclose the share of their turnover, capital (CapEx) and operational expenditure (OpEx) associated with environmentally sustainable economic activities as defined in the Taxonomy Regulation and the EU Taxonomy Climate Delegated act. That act, which also came into force at the start of 2022, established the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation, adaptation, or damage.

The Commission followed this up with the more controversial Complementary Delegated Act, which concerned the inclusion of certain gas and nuclear activities in the taxonomy. Despite opposition in the Parliament and Council, the act was approved in July 2022 and will apply as of January 2023. The Commission said the move was necessary to ensure investment in gas and nuclear to support the energy transition, but the Dutch centre left MEP, Paul Tang, from the Progressive Alliance of Socialists and Democrats group, said it was a "painful and shameful setback for Europe as a global leader in the fight against climate change". At the time of writing, some member states are reportedly considering launching a case in the European Court of Justice to block the implementation of the Complementary Delegated Act.

The Commission is due to adopt further delegated acts on the other four environmental objectives of the EU Taxonomy: the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems. In preparation for this, the Platform on

Sustainable Finance, an advisory group formed of experts in sustainable finance and other environmental stakeholders, published a report with recommendations on technical screening criteria in March, followed by a complementary report on November 28. Given the experience with the previous delegated acts, McGuiness noted that the Commission wants to ensure there is enough time for consultation. The Commission also signalled a more phased process leaving the more controversial issues such as forestry for the later stages.

Next steps

With less than a year and a half to go before the next European Parliament elections, there is unlikely to be time for the EU to launch any new major sustainable finance initiatives. The Commission has said it will focus on concluding the existing files and ensuring new rules mesh with instruments already in place. For example, on the SFDR, the Commission has said it hopes a set of soon-to-be published question and answer document and the Regulatory Technical Standards (RTSs) that come into effect on January 1, 2023, will help address some of the practical issues with that regulation. In parallel, the Commission will conduct an assessment to see whether any changes to the Level 1 text are also necessary. In terms of the ESG ratings, the Commission is considering a proposal to bring more transparency to the market and introduce rules on ESG rating agencies' operations.

The EU's sustainable finance agenda has been developing steadily over the last five years, but as this report shows, there remains much work to do. The Commission has said it plans to report on the implementation of the overarching strategy by the end of 2023 and this will likely feed into the work of the next Commission.

Igor Kostadinovski is the deputy head of Dods EU Political Intelligence in Brussels. He monitors and writes about EU policy developments of interest to the financial services sector.

About Dods Political Intelligence

We provide insight, intelligence and impact through our comprehensive suite of policy tools. Our services comprise of three main elements: *Dods Consultancy* – based in Brussels and London, our industry experts offer real-time analysis and impartial guidance on the latest policy developments and trends. *Dods Monitoring* – our platform offers instant alerts and contextual insight from over 13,000 sources across the UK and the EU. *Dods People* – the original who is who in politics, Dods Parliamentary Companion, was established in 1832. Today, our stakeholder management tools cover the UK and the EU, helping you identify and communicate effectively with key contacts.

Contact Us

For further information, please visit dodspoliticalintelligence.com or contact us at
customer.service@dodsgroup.com or
UK customer service +44 207 593 5500 or
EU customer service +32 274 182 30