Simplifying the EU sustainability framework

The Chair opened the discussion by citing page 318 of the Draghi report, which says, 'The EU's sustainability reporting and due diligence framework is a major source of regulatory burden, magnified by a lack of guidance to facilitate the application of complex rules and to clarify the interaction between various pieces of legislation'.

1. The challenges of the current EU sustainability framework

A regulator emphasised that the introduction of the framework in 2018 and 2019 has accelerated the progress on the 2030 and 2050 climate goals. The legislation to create several frameworks was passed in record time: the Sustainable Finance Disclosure Regulation (SFDR), the taxonomy, the benchmark regulation, the European Sustainability Reporting Standards (ESRS) prepared by the European Financial Reporting Advisory Group (EFRAG) and the Corporate Sustainability Reporting Directive (CSRD). One of the main issues with the sustainability framework is its complexity. There are uncertainties and inconsistencies between the many different pieces of legislation. Secondly, the high cost of implementation makes EU firms less competitive than international firms. Finally, there is a risk of greenwashing. One additional key issue is the inadequate quality of sustainability data. The European Securities and Markets Authority (ESMA) has been trying to identify greenwashing by analysing a variety of datasets. When ESMA compared the estimated data from data providers with the actual data, it found significant discrepancies.

An industry speaker stated that it was important to praise the EU for its ambition and commitment to tackling climate change. One of the key challenges in the sustainability framework is the implementation of CSRD in the ESRS. The ESRS mandates a complex set of disclosures and contains over 1,000 data points. There are clear benefits to standardisation, but the ESRS standards are excessive. This is arguably mitigated by the materiality statement, which places a filter on the reporting. However, companies are required to prove whether each data point is material or not, which takes a significant amount of time and money. This creates a competitive drag for EU firms. The introduction of sector specific reporting standards will be more meaningful, but these standards will not remove the drag created by the current cross sectoral requirements.

An industry representative remarked that the Draghi report captured that the EU's sustainability and due diligence regulations are a major burden for companies, which was already well known. However, it is important to remember that sustainability is a significant policy objective. The purpose of these regulations is to help to redirect capital to prevent catastrophic climate change and biodiversity extinction; the burden on the economy is likely to be significant. The question is not whether it is too great a burden but whether it is the right burden. The real problem is that policymakers went very far very fast because there was a need and a willingness to solve the problem. Mario Draghi noted in his report that the lack of clear guidance in the regulatory framework is causing a magnification effect. It is not clear whether it is necessary to implement everything or only some aspects of the materiality assessment.

Despite the high degree of complexity, it is important to keep making progress. The financial industry is 'in the middle of the river', but there is a better world on the other side. The trap to avoid is a cycle of paper compliance that solves nothing and has little real world impact. The current framework should be stabilised and calibrated and the burdens should be reduced through simplification, but it is impossible to return to a world in which information on sustainability is not shared.

There is some good news, however. From 2013 to 2023, the top 15 utilities rated by S&P have doubled their investment from €50 billion to €90 billion while decreasing scope 1 and scope 2 emissions by almost 40%. Despite a significant outlay of capital, the credit rating implications have been limited. On average, S&P's ratings have fallen by one notch over that period. Firms are doubling their investment, but credit quality has not been affected significantly. S&P's look forward research indicates that the 2030 decarbonisation targets for the private sector are manageable from credit and operational perspectives. The outlook is relatively benign, which means that now is the time to transition. Some sectors will only have two or three cycles of investment before 2050. For many CFOs, 2030 is 'tomorrow'. There are also some challenges. The data is not yet good enough, and this will take time to improve. S&P's studies suggest that reliable access to data and disclosure and the application of screening mechanisms will go hand in hand. The SFDR, the Paris Aligned Benchmark (PAB), the Climate Transition Benchmarks Regulation (CTBR), the CSRD and the taxonomy must all work together. Of the 2,000 companies that were assessed for the taxonomy last year, only 31% of non financial corporates made any taxonomy disclosures. This dropped to 25% in the financial markets. Utility companies are doing well at 42%, but only 17% of energy companies made any disclosures. There is a need for significant progress in these hard to abate sectors.

An industry representative agreed that the volume of regulation and the speed of its rollout act as a drag on the efficiency of the regime. Over the last few years, financial firms have been asked to implement level 1 legislation before seeing the final level 2 texts. After implementing level 1 measures, firms often discover that other parts of the legislation need amendment. Even after the supplementing regulations are in place, helpful clarifications are provided in the supervisory guidance. This is an important tool for communicating the thinking of regulators, but it can border on rule making, which adds to uncertainty and the need to make changes continuously. This significantly increases cost. As well as financial cost, there is a strain on the important internal resources needed to operate a well functioning bank. The legislators and regulators often underestimate the complexity of financial IT systems, and the lead time required to make substantial changes. The limited resources in bank IT departments are needed to keep banks operational and to implement all these regulatory changes.

2. Implementing the sustainability framework: perspectives and challenges

An official stated that the objective of the framework is not to overburden firms. While the Draghi report suggests that the burden is undue, there is a difference between justified burdens and unjustified ones. The EU has reached a critical moment in the journey to standardise corporate reporting. The first wave of companies is currently preparing sustainability statements in accordance with the CSRD and the Sustainability Reporting Standards (SRS) in advance of publication in early 2025. The situation prior to the CSRD and the SRS was unsatisfactory. It was fragmented, uncoordinated, insufficiently qualitative and prone to greenwashing. The purpose of standardisation is not to burden; it is to increase quality and simplify. In EFRAG's view, simplification happens via standardisation. Good standard setting reduces cost in other systems. Without standardisation, data providers might only provide lower quality data because the data itself is neither free of charge nor standardised. The introduction of the International Financial Reporting Standards (IFRS) was a challenge of similar difficulty. It was a success because it introduced a common language, although many people considered it impossible at the time.

EFRAG recognises the challenges and the corresponding priorities. First, in a liberal economy, transparency is key. Quality data must be the starting point, and there will need to be coordination and consistency in the regulations. Secondly, there must be global consistency. There should be no duplication or replication of reporting. EFRAG has achieved a degree of interoperability with the International Sustainability Standards Board (ISSB), the Global Reporting Initiative (GRI) and the Taskforce on Nature related Financial Disclosures (TFND) and it is working hard on the greenhouse gas protocol. Thirdly, implementation must be supported. EFRAG dedicates significant resources to its Q&A platform and issuing implementation guidance. Fourthly, there must be good standard setting. The standard setters have a responsibility to move at the right pace and not to make too many changes. There cannot be any 'stop and go' in the process of regulation. The political authorities can set the pace, but EFRAG must produce the technical material. Finally, SMEs should not be unnecessarily burdened by the framework. The creation of a voluntary SME standard with fewer than 30 indicators will enable SMEs to participate in the transition via their accountant or legal advisor. The standard setters can and will do better. When crossing a river, it is better to focus on reaching the other side than judging the efficiency of the journey.

The Chair commented that the introduction of IFRS is an example of another stormy river crossing. It is useful to think about the current challenges with the benefit of this experience.

An official agreed that the sustainability framework is a moving target. The first reports from the CSRD will soon be published. It is important to remember that the framework is about digitalisation as well as sustainability. EFRAG has recently published its XBRL standard. The data in XBRL format will have to be audited, and this audit will have to be done on a limited assurance basis before it can be done on a reasonable assurance basis. Ultimately, this data will go to the European Single Access Point (ESAP), which is an ESMA data platform. The ESAP will be an extremely broad platform. It will have research functions that are truly database like. It will be possible to filter the data according to country, business size and sector. The Corporate Sustainability Due Diligence Directive (CSDDD) is an interesting piece of legislation that will change the approach entirely. It is not about transparency; it is about civil liability, sanctions and competent authorities. The sustainability framework is not perfect, but when the data becomes available, it will make clear whether firms are green and whether they comply with the taxonomy. However, the speed at which the framework is being implemented is problematic. Everything is happening at once, which is extremely difficult to manage.

3. European companies need to be helped to implement the framework

A consumer representative emphasised the importance of the objective of the sustainability agenda. Transparency is being blamed for the additional burden on companies, but it is a precondition to the next set of actions on sustainability. It will be important to help companies implement the framework, however. EU companies need to be allowed to focus on what is essential. Transparency is not an end in itself. Helping companies with implementation is more important than trying to eliminate parts of the regulatory framework. Other sectoral legislation and actions beyond transparency, such as actions on risk management or fostering real economy transformation, are much more difficult, especially in the financial services industry. If other actions were effectively being taken, reporting on those would be simpler.

It is important to bear in mind the complexity of information chains on sustainability issues and the complexity of the financial system itself. There are other environmental objectives alongside climate objectives.

There are smaller and simpler firms, but there are also companies that offer complex structured products alongside traditional lending. The process of reporting will be complex as long as complex products form part of the ecosystem. Ultimately, it is important to focus on real economic activity and ensure that reporting remains connected to real world objectives.

4. Improving the EU sustainability framework

An official observed that there is considerable room for improvement in the framework, but every attempt to simplify it seems to introduce more reporting obligations. Regarding SFDR, the use of labels would make products more understandable to retail investors. There is also scope for improvement on transition finance. The transition needs to be financed, and this should be defined in level 1. It is very difficult to keep up with the plethora of papers, explanations and FAQs published by the European institutions. It would also be extremely useful for the transition pathways to be defined at European level. It makes no sense for these pathways to exist only in a subset of countries.

A consumer representative noted that the parallel development of many different legislative initiatives has led to duplications, inconsistencies so that there are areas for streamlining. The two main goals should be coherence and clarity. This will require the alignment of many different pieces of legislation such as SFDR, CSRD, PRIIPS and definition of sustainability preferences per MiFID and IDD. Consistent definitions and a sufficient level of transparency for retail investors are especially important because retail investors are increasingly being called upon to salvage the capital markets union (CMU) project. It is important to use the same definitions across different pieces of legislation. Unless such clarity is achieved, it will not be possible to achieve the ultimate objectives of the sustainable finance framework. People talk about the growth in sustainable investment, but there is not yet a single definition of a sustainable or a transition product. There are other issues to address, such as overlapping requirements in CSRD and entity level disclosures in SFDR, but clarity and common baselines, including on sectoral pathways and scenarios, are the most fundamental need.

An industry speaker stated that EFRAG should revisit the ESRS. Streamlining these requirements would create the right foundations for sector specific standards and transition plans. Regulators and supervisors need to have the political and institutional courage to revisit the ESRS in order to establish a stronger foundation on which to make progress.

An industry representative noted that there is a significant mismatch in the use of the SFDR requirements for corporate disclosure. There is insufficient data on some of the mandatory indicators in the principal adverse impacts (PAIs). There is 100% coverage on some of these indicators and 0% coverage on others. There could be greater alignment if the PAIs measured less but measured it better. ESMA recently proposed the development of a single common reference of sustainability. As currently constituted, the taxonomy will struggle to provide this kind of clarity. There is a middle ground to find here. For example, the use of SFDR labels could enable a distinction to be made between the taxonomy definition of sustainability and the sustainability that is needed in practice for transition.

An industry speaker commented that it is important to understand the issue at a technical level. The lack of consistency and harmonisation across various rules, is an issue that must be dealt with. As an example, the transition planning expectations in the CSRD also appear in the CSDDD guidelines, but transition activities are not covered by the EU taxonomy. There are also issues related to scoping. In some areas, the CRD IV requires transition planning work at European subsidiary level, while the CSDDD imposes requirements at both entity and group level. It would be more productive to focus on the elements of the framework that can help EU banks to create credible transition plans and strategies to support clients around the world. As a starting point, the EU banking sector needs to be able to quantify climate related and environmental (C&E) risk. The sector has produced materiality assessments which are currently being integrated into stress testing frameworks. If banks understand these risks, they will be able to support their clients through the transition. Taking an outcome based approach is the key to making progress in the real economy, which is the ultimate aim of the framework. Sustainability reporting should not be a compliance exercise. The focus should be on helping and financing clients on the journey to net zero and using these frameworks to improve transparency, which will assist in the creation of better benchmarks and drive consistency in global standards.

It is also important to consider the need for proportionality. In large groups with many smaller local entities, actions at group level often have a greater impact than actions at local entity level. Increasing the proportionality in the framework would allow larger groups to make greater progress. The development of bank transition plans should be guided by significant client engagement. This kind of disclosure should not be a compliance exercise. It should be based on an understanding of how financial services firms can support their clients. On balance, the existing framework does not need a complete overhaul, but some recalibration will be necessary. The key components of this recalibration will be consistency and proportionality. An industry representative noted that, while there are amendments that the industry would like to make to the framework, it is preferable to have a period of calmness and predictability.

5. Conclusion: balancing the competing priorities for change

A regulator stated that the main priority should be to simplify disclosure, which includes creating a product categorisation system for sustainable and transitional investments, and to improve data quality.

An official emphasised the importance of digitalisation and transition pathways.

Another official remarked that it is important to reduce reporting for SMEs, but there is no alternative to EFRAG's Voluntary Reporting Standard for SMEs (VSME).

A consumer representative noted that the two key priorities are to align the different aspects of the legislative framework and to clarify the requirements for transition plans by producing guidance on sectoral and geographical pathways and scenarios.

An industry speaker stated that the key priorities are to converge on global standards for transition scenarios, which will ensure international delivery, and to review the EU regulatory process itself. The forthcoming report entitled 'Less is More' should be considered alongside the Draghi report.

An industry representative highlighted the importance of fixing SFDR, defining sustainable finance and creating a robust framework for a definition of 'do no significant harm' in order to avoid the trap of greenwashing. The key priority is to focus on the transition. Theoretical definitions of sustainable finance that might apply in 2050 are less useful than definitions that apply to the transition plans that will be implemented over the next five years.

An industry speaker agreed that sectoral pathways will be an important part of the future development of these frameworks. The use of this approach in Japan has helped to ensure that the private sector and the public sector share the same set of assumptions about the path to net zero. These pathways would also provide banks with better benchmarks for assessing whether their clients' plans are credible or not as well as providing support with respect to reputational risks.

An industry representative stated that there should be a clear acknowledgement from the European supervisors that the CSRD will not work without accurate and reliable data from the real economy.