Sustainable Finance: from transparency to behavioural rules

Joost Mulder
IESE Business School
19 October 2021

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Agenda

- Regulation of (sustainable) finance
- Sustainable finance: taxonomy and context
- Use of the disclosure framework
- Impact on financial and non-financial firms

Why regulate (sustainable) finance

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Politics and financial industry

- Presented as highly technical
- But not unique and lots of human-made complexity: derivatives, short selling, capital requirements
- In the end these are all political trade-offs between the sectors' profitability ("economic growth") and other societal interests such as financial stability

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Impact of finance on society

- Retail finance and payments, foreign exchange, export credit (euro, cheap payments)
- Financial markets: trading, equity/bond issuance ("liquidity creation")
- Money creation (bank stability)
- But most importantly: credit allocation (sustainable finance)

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Sustainable finance: taxonomy and context

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for their power plants. They fear that without the highest green label in the taxonomy, capital will desert a technology that is so prized in countries such as France.

The same logic applies for pro-gas countries in southern and eastern Europe who do not want the taxonomy to penalise a fuel that is crucial in reducing their emissions as they switch from dirtier coal or lignite.

But green designation for both would leave the EU open to accusations that it was “greenwashing” rules that were designed precisely to stamp out the practice by guiding investors on what counts as genuinely sustainable economic activity. The UK and US have said they will each come up with their own taxonomies, moves that risk gazumping the EU's efforts to become a global standard setter for investors.

“It is very delicate balance to strike. Countries care about their right to choose their energy mix and markets and investors are watching us to come up with credible rules,” said an EU official.

Such are the political sensitivities that the commission is likely to further delay taking a stance, hoping perhaps that an easing of the energy crisis after the winter will simmer down tensions over nuclear power.

Council of the European Union

Brussels, 15 September 2021
(OR. en)

11798/21

EF 272
ECOFIN 842
DELACT 201

'I/A' ITEM NOTE

From:	General Secretariat of the Council
To:	Permanent Representatives Committee/Council
No. Cion doc.:	C(2021) 2800 final - ST 9607/21+ADD1+ADD2
Subject:	Delegated act in the area of financial services: COMMISSION DELEGATED REGULATION (EU) …/... of 4.6.2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as

1. The Commissi
accordance wit
European Unio
June 2020 of tl
framework to f

2. In accordance with Article 23(6) of Regulation (EU) No 2020/852, the Council has four months, i.e. until 8 October 2021 to object to the delegated act mentioned above. Article 23(6) also provides that the objection period may be extended by two months at the initiative of the Council. During the consultation in the framework of the Working Party on Financial Services and Banking Union, which expired on 15 September 2021, the required majority for the extension of the objection period was reached.

3. It is therefore suggested that the Permanent Representatives Committee invites the Council to extend the objection period by two months.

Taxonomy: how we got here

- Multi-year multi-step process in which the actual Regulation took only a few years:
  - 2016-2018: High-Level Expert Group on Sustainable Finance (mixed representation)
  - 2018-2019: Legislative process EP/Council
  - 2019-2020: Technical Expert Group (statutory "seats" defined in legislation)
  - 2020-2021: Commission Delegated Acts / Standards (due 21 April, still contentious)

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Taxonomy: a key building block

Taxonomy Regulation (2018)

E, S and G minimum safeguards

Other International Frameworks

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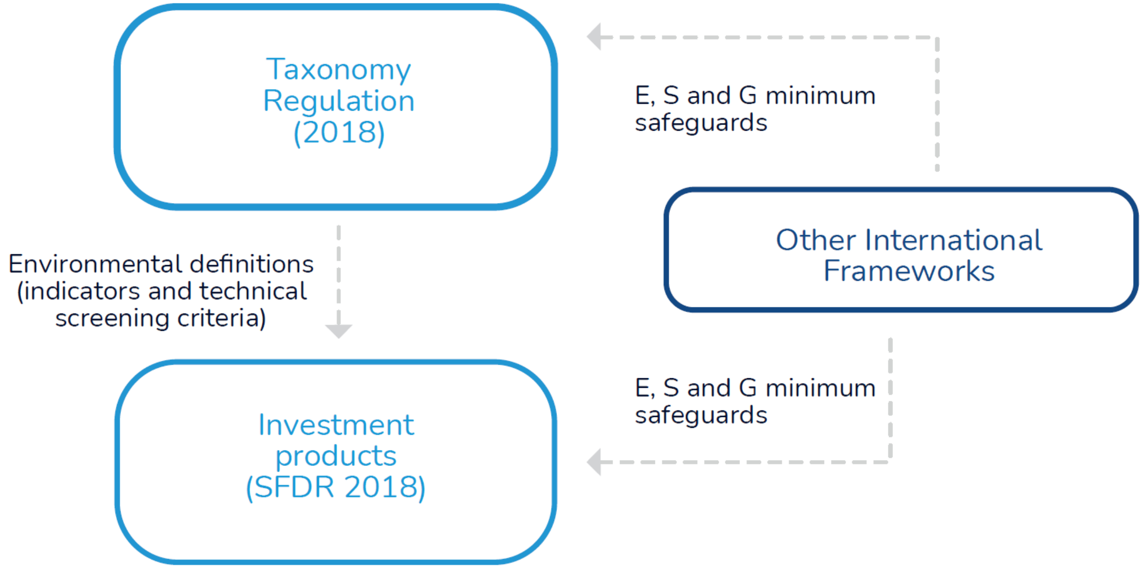
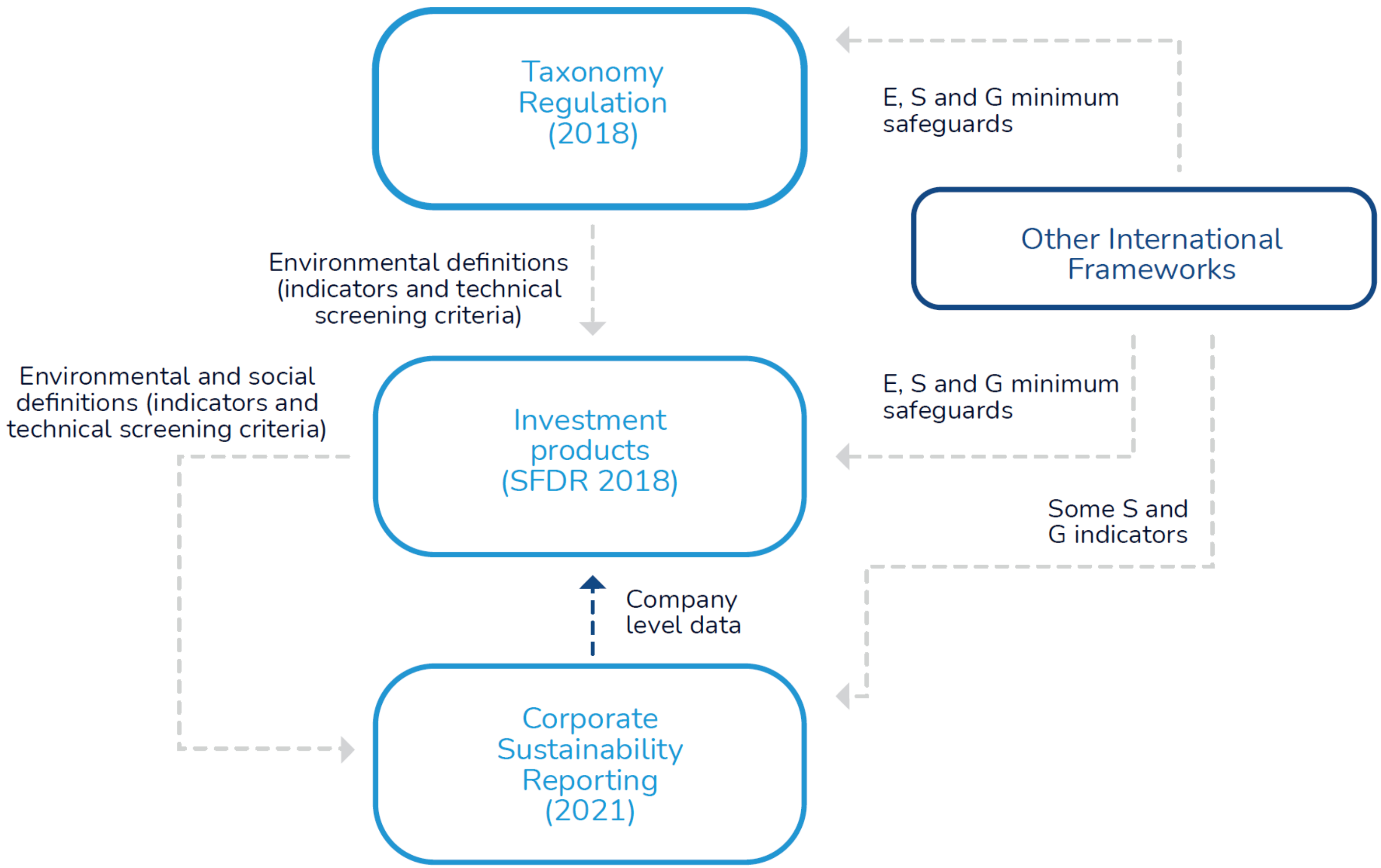
Taxonomy: a key building block



Taxonomy: a key building block



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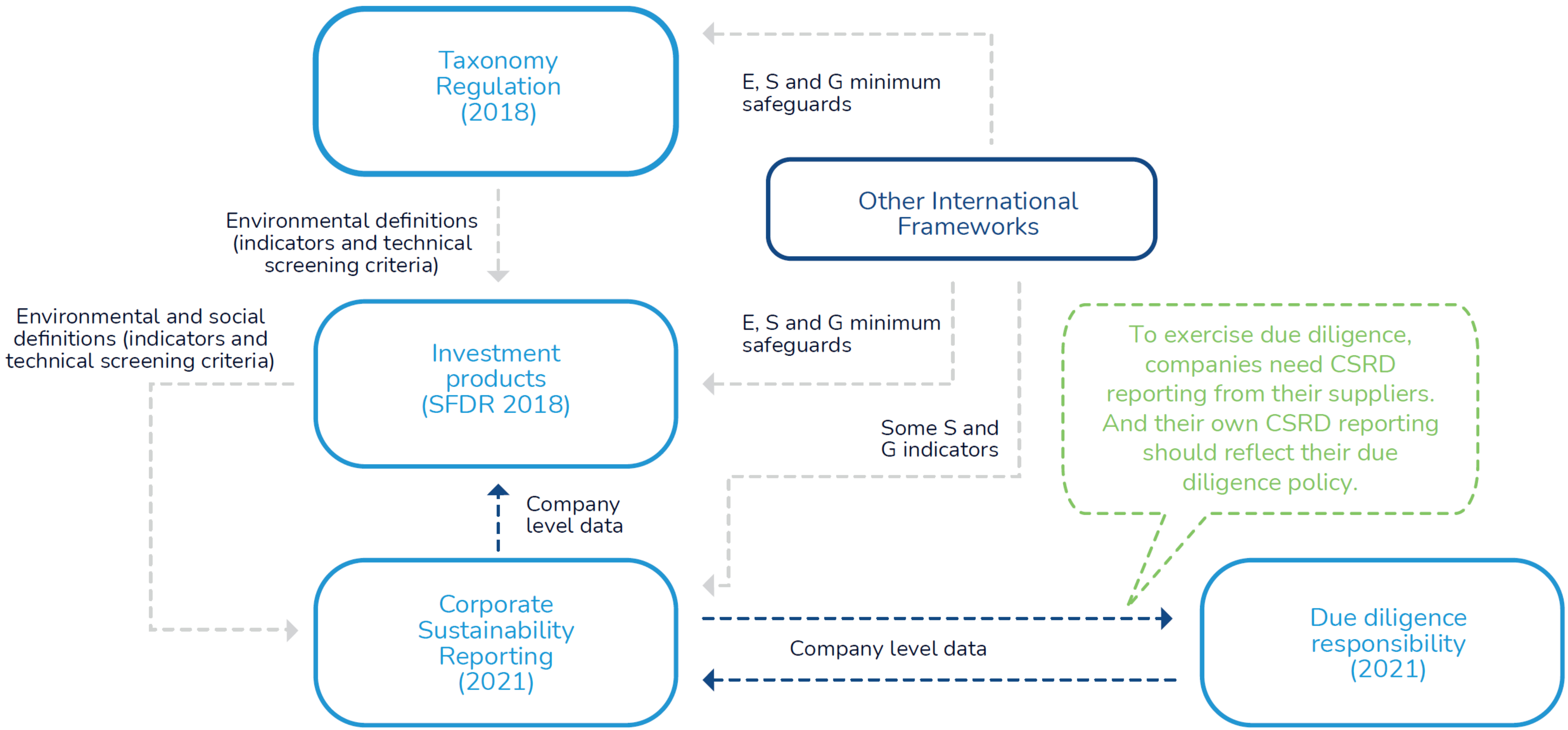
Taxonomy: a key building block



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Taxonomy: devil in the detail

- Decided
  - Sectorial exclusions (forestry, hydro)
  - Governance (Platform)
- Outstanding
  - Sectorial exclusions (nuclear, gas)
  - Social and good governance taxonomy?
  - “Brown” taxonomy?
- Slow timetable and low ambition level

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Uses of the disclosure framework

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Taxonomy & co: expected uses

Announced in 2018

- EU Green Bond Standard:
  proposal July 2021 (too late for NextGenEU)
- EU Ecolabel: overdue, stalled because of nuclear

Failed

- Recovery and Resolution Fund (2020):
  framework not ready*, amended Rio Markers instead

Potential

- …

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Potential

- Capital requirements
  (Green Supporting Factor / Brown Penalizing Factor)
- Sustainable Products Initiative (Green Procurement Rules)

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Impact on financial & non-financial firms

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Impact disclosure framework (1)

Impact on the <u>financial sector</u>

- Core of the disclosure framework: Taxonomy + SFDR
- Formal scope: placing products on EU market (both files)
- Future impact likely (e.g., risk-sensitive capital requirements)
- Transparency and comparability itself will have an impact (e.g. through market valuation of investments in potential stranded assets)
- Extraterritorial impact:
  - Non EU-firms placing products on the EU market
  - EU-subsidiaries of non-EU firms
  - Potential de facto global standard (Brussels effect)

=> Beware, rules for non-financial firms also apply

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Impact disclosure framework (2)

Impact on <u>non-financial</u> sector firms

- Core of the disclosure framework: Taxonomy Art 8 + CSRD
- Scope: large firms >250 staff and smaller EU-listed firms (tbc)
- Pending overhaul of NFRD into CSRD, Taxonomy's Article 8 prescribes very minimal sustainability reporting requirements (3 KPIs) for firms already subject to the NFRD so that their financiers can reporting under SFDR
- Indirect impact **<u>on all non-financial firms</u>**:
  – SFDR (data required for the PAI statement)
- Extraterritorial impact:
  – Firms financed by EU counterparties subject to SFDR (above)
  – Non-EU firms listed in the EU (tbc)
  – Potentially: all firms supplying EU firms (to allow EU firms to meet new due diligence requirements)

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Key investor information for investors in Switzerland
This document provides you with key investor information about this fund. It is not marketing material. The information is required by law to help you understand the nature and the risks of investing in this fund. You are advised to read it so you can make an informed decision about whether to invest.

DWS Invest German Equities
Share class: USD LC, ISIN: LU0740824916, Security code: DWS1AH, Currency: USD

a sub-fund of DWS Invest. The management company is DWS Investment S.A., a member of the DWS Group.

Objectives and investment policy

The fund is actively managed. The fund is managed in reference to a benchmark. The objective of the investment policy is to achieve a medium to long-term sustained capital appreciation that exceeds the benchmark (CDAX (RI)). In order to achieve this, the fund mainly invests in equities of German issuers; a broadly-based investment in blue chips as well as selected secondary stocks is the primary focus. In this context, the selection of individual investments is the responsibility of the fund management. The majority of the fund's securities or their issuers are expected to be components of the benchmark. The fund management will use its discretion to invest in securities and sectors that are not included in the benchmark in order to take advantages of specific investment opportunities. The portfolio is not necessarily expected to have a similar weighting to the benchmark. In regard to its benchmark, the sub-fund positioning can deviate significantly (e.g. by a positioning outside of the benchmark as well as a significant underweighting or overweighting) and the actual degree of freedom is typically relatively high. A deviation generally reflects the fund manager's evaluation of the specific market situation, which may lead to a defensive and closer or a more active and wider positioning compared to the benchmark. Despite the fact that the fund aims to outperform the benchmark, the potential outperformance might be limited depending on the prevailing market environment (e.g. less volatile market environment) and actual positioning versus the benchmark. The currency of the fund is EUR. Returns and gains are not distributed but are reinvested in the fund. You may request the redemption of shares generally on a daily basis.

Risk and reward profile

Lower risk — Higher risk

Potentially lower reward — Potentially higher reward

1	2	3	4	5	6	7

The calculation of the risk and reward profile is based on historical data that cannot be used as a reliable indicator for the future risk profile. This risk indicator is subject to changes; the classification of the fund may change over time and cannot be guaranteed. Even a fund that is classified in the lowest category (category 1) does not represent a completely risk-free investment. The fund is classified in category 7 because its share price may fluctuate very strongly and the likelihood of both losses and gains may therefore be very high. The following risks could be of particular significance for the fund: The fund invests its assets in selected regions or sectors. This increases the risk that the fund may be negatively influenced by the economic and political conditions in the respective regions or sectors. The fund invests in equities. Equities are subject to strong price fluctuations and thus also to the risk of price decreases.

A more detailed description of risks and other general information can be found in the risk section(s) of the prospectus.

Charges

The charges you pay are used to pay the costs of running the fund, including the costs of marketing and distributing it. These charges reduce the potential growth of your investment.

One-off charges taken before or after you invest	
Entry charge	5.00 %

The entry and exit charges shown are maximum figures. In some cases you might pay less - you can find this out from kiid generator

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Lower risk. Higher risk. Exchange Rate Risk. The Fund invests in companies which may have share prices denominated in currencies other than the Euro and may ...

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Compliance

- Technical detail (indicators, format) in delegated legislation

Example (finance): SFDR PAI

Indicators applicable to investments in investee companies						
Adverse sustainability indicator		**Metric**	**Impact [year n]**	**Impact [year n-1]**	**Explanation**	**Actions taken**
CLIMATE AND OTHER ENVIRONMENT-RELATED INDICATORS						
Greenhouse gas emissions	1. GHG emissions	Scope 1 GHG emissions				
		Scope 2 GHG emissions				
		From 1 January 2023, Scope 3 GHG emissions				
		Total GHG emissions				
	2. Carbon footprint	Carbon footprint				
	3. GHG intensity of investee companies	GHG intensity of investee companies				
	4. Exposure to companies active in the fossil fuel sector	Share of investments in companies active in the fossil fuel sector				

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Compliance

Example (non-finance): NFRD/CSRD

ANNEX II - Templates for the KPIs of non-financial undertakings

Template: Proportion of turnover from products or services associated with Taxonomy-aligned economic activities – disclosure covering year N

Economic activities (1)	Code(s) (2)	Absolute turnover (3)	Proportion of turnover (4)	Substantial contribution criteria: Climate change mitigation (5)	Substantial contribution criteria: Climate change adaptation (6)	Substantial contribution criteria: Water and marine resources (7)	Substantial contribution criteria: Circular economy (8)	Substantial contribution criteria: Pollution (9)	Substantial contribution criteria: Biodiversity and ecosystems (10)	DNSH criteria ('Does Not Significantly Harm'): Climate change mitigation (11)	DNSH criteria ('Does Not Significantly Harm'): Climate change adaptation (12)	DNSH criteria ('Does Not Significantly Harm'): Water and marine resources (13)	DNSH criteria ('Does Not Significantly Harm'): Circular economy (14)	DNSH criteria ('Does Not Significantly Harm'): Pollution (15)	DNSH criteria ('Does Not Significantly Harm'): Biodiversity and ecosystems (16)	Minimum safeguards (17)	Taxonomy-aligned proportion of turnover, year N (18)	Taxonomy-aligned proportion of turnover, year N-1 (19)	Category (enabling activity or) (20)	Category '(transitional activity)' (21)
		Currency	%	%	%	%	%	%	%	Y/N	Y/N	Y/N	Y/N	Y/N	Y/N	Y/N	Percent	Percent	E	T
A. TAXONOMY-ELIGIBLE ACTIVITIES			%																	
A.1. Environmentally sustainable activities (Taxonomy-aligned)																				
Activity 1 [3]				%	%	%	%	%	%		Y	Y	Y	Y	Y	Y	%		E	
Activity 2			%	%	%	%	%	%	%	Y	Y		Y	Y	Y	Y	%			
Turnover of environmentally sustainable activities (Taxonomy-aligned) (A.1)			**%**	%	%	%	%	%	%								**%**			
A.2 Taxonomy-Eligible but not environmentally sustainable activities (not Taxonomy-aligned activities)																				
Activity 1			%																	
Activity 3			%																	
Turnover of Taxonomy-eligible but not environmentally sustainable activities (not Taxonomy-aligned activities) (A.2)			**%**																	

[3] Activity 1 is Taxonomy-eligible in its entirety. However, only a proportion of it is Taxonomy-aligned. Therefore, Activity 1 may be reported under both A1 and A2. However, only the proportion reported under A1 may be counted as Taxonomy-aligned in the turnover KPI of the non-financial undertaking.

Thank you

Joost Mulder

mulder@bettereurope.eu

www.bettereurope.eu

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