SUSTAINABILITY

Sense and sustainability

The pace and rigour of EU policymaking designed to promote environmentally sustainable business and investment practices are increasing. David Adams **looks at the latest developments in an increasingly complex regulatory and legal landscape**

WRITTEN BY **DAVID ADAMS,** A FREELANCE JOURNALIST

As extreme weather events wreak havoc across the globe and scientists issue warnings about 'tipping points', corporates and politicians are stepping up their responses to the climate crisis. The EU is now arguably the world-leading jurisdiction for development of policy and regulation on environmentally sustainable and socially responsible business and investment practices. As major institutional investors, pension funds across Europe find themselves at the heart of a complex patchwork of evolving legislation and regulation.

"Over the past five years the European Commission has put in place the building blocks of its sustainable finance framework: A taxonomy of sustainable activities, disclosure frameworks; and investment tools including a Paris-aligned climate benchmark and a green bond standard," says Principles for Responsible Investment (PRI) senior policy analyst, Ben Leblique.

ISS ESG global head of ESG research, Bonnie Saynay, commends the pace of the EU's framework: "But now they are being applied in practice, many of these frameworks will need to be improved to ensure consistency, comparability, clarity and usability."

Discussing disclosures

There are three major changes underway that will affect pension funds and their investment strategies. The first is proposed changes to the Sustainable Finance Disclosure Regulation (SFDR), which mandates ESG disclosure obligations for asset managers and other financial markets participants. Additional disclosures are required if a financial product is classified under Article 8 (if it promotes ESG characteristics but ESG investing is not a core objective) or Article 9 (if sustainable investment is a core objective).

Between April and July, the three European Supervisory Authorities ran a consultation on amendments to delegated regulation of the SFDR. These included extending the list of indicators for disclosure of adverse environmental and social impacts; and changing the way information about those impacts and targets for improvement are presented.

PensionsEurope secretary general and CEO, Matti Leppälä, says his organisation has concerns about the criteria for Articles 8 or 9; and about the overlap between the SFDR and the IORP II Directive. A pension fund that takes ESG factors into consideration and discloses this is effectively classified as an Article 8 fund, but Leppälä highlights difficulties funds may have in obtaining data for required disclosures, particularly the adverse social impacts of investments.

Both EIOPA and PRI have stressed the need for proportionality for pension funds in scope. PRI has also highlighted the fact that the pan-European Personal Pension Products (PEPP) regulation requires PEPP providers to take into account the consequences of investment decisions on ESG factors, as part of the prudent person rule. The PRI wants similar requirements included in IORP II. Leppälä stresses the need for closer alignment between the SFDR and the taxonomy. "That would reduce the regulatory burden and simplify reporting," he says. The PRI has urged the commission to align investor engagement policy disclosures under the SFDR with taxonomy targets and sustainability outcomes. But DWS global head of ESG advisory, Dennis Haensel, highlights how much time

may pass before the taxonomy is available for all economic activities, allowing it to become the efficient framework referred to in the SFDR.

Resetting sustainability reporting standards

In June, the European Commission adopted the European Sustainability Reporting Standards (ESRS), which companies will use to report sustainability-related impacts, opportunities and risks. A scrutiny process of the ESRS by the European Parliament and European Council is underway, with reporting under the new rules likely to start in 2024. ESRS will compel businesses to explain why they might deem climate-related factors to be non-material, but the PRI, European Association of Paritarian Institutions (AEIP) and others would like to see disclosure indicators relevant to SFDR made mandatory.

"Instead of aligning the corporate framework with the financial services framework, we're going to allow companies to decide whether certain data points are material for investors to know," AEIP board member, Matthies Verstegen, notes.

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Saynay suggests that unless this is changed "divergence between the regimes" will hamper interoperability. She acknowledges that EFRAG is convening advisory panels to develop standards for capital markets, banking, and insurance, including pension funding.

Debating due diligence

The third significant regulatory/legislative development is the proposed Corporate Sustainability Due Diligence Directive (CSDDD). It will require IORPs and businesses to identify and/or prevent environmental and human rights adverse impacts, although the final form of the due diligence requirements is not yet settled. The directive's being debated and should be finalised before the European Parliament elections in 2024.

Leblique says the PRI's view is that if CSDDD requirements are risk-based and take differing approaches to stewardship into account, the new directive will "support investors' sustainability assessments, enhance risk analysis … impact prevention, mitigation and remediation; and provide greater understanding of companies within scope". It will also help investors "conduct better-informed engagement" with investees.

Saynay feels not enough attention has yet been paid to the CSDDD. "This may turn out to be the real game changer," she says. "CSDDD requires mitigating action and introduces not only enforcement through supervisory authorities but also a liability mechanism."

One key question is whether provision of investment activities – and pension funds' investment activities – will be included.

Verstegen says the AEIP's view is that the commission's proposals are not appropriate for pension funds, because they are founded on an assumption of a contractual relationship with a business, which could be leveraged to force action on issues like human rights or environmental impacts.

Embracing the agenda

How are pension funds responding to these imminent or proposed changes? Leppälä sums up the response as "more or less positive", but Verstegen raises concerns about how these regulations might affect smaller pension funds. "The smaller the pension fund gets, the less likely it is to opt in," he says.

Haensel emphasises the value of harmonisation and standardisation of regulation regarding exclusion criteria, requirements, and definitions of adverse impacts within different member states. "Consolidating these measures should be a key priority for EU policymakers in the coming years," says Leblique, adding: "Efforts should focus on improving the consistency of the different measures, particularly between SFDR and the taxonomy regulation; and addressing data gaps."