The EU Green deal

The regulatory green wave impacting our shores

pwc

Emerging from the European Commission in 2019, the EU Green deal is the bloc's ambitious plan to tackle climate change. Ultimately, the EU will reach net-zero greenhouse gas emissions by 2050 to try and maintain global temperatures. This regulation has far reaching impact. Australian companies operating in, or seeking investment from EU entities, will need to adhere to taxonomy and regulatory requirements.

What is ESG?

The term 'ESG', which stands for 'Environmental', 'Social' and 'Governance' goes beyond environmental issues like climate change and resource scarcity - it encompasses all non-financial topics that are not typically captured by traditional financial reporting. ESG covers various risks and opportunities that impact a company's ability to create long term value. ESG includes social issues like labour practices, governance matters like diversity and inclusion, and environmental considerations like greenhouse gas emissions.

What is the EU Sustainable Finance Action Plan (Green Deal)?

Sustainable finance is integral to how the EU will deliver on its policy objectives under the European Green Deal. The Sustainable Finance Action Plan looks at how finance can support economic growth while reducing impact to the environment by taking into account environmental, social and governance (ESG) aspects when making investment decisions.

The key goals of the plan are:

- Economic growth and long-term investment from the financial sector translates into sustainable economic activities and projects
- Capital is redirected to sustainable investment and away from sectors contributing to climate change i.e. fossil fuels
- The financial risks of climate change for the 27-nation bloc are minimised

The Sustainable Finance Action Plan moves away from the long-held view that economic growth is tied to resource use. Instead, the EU is looking to stimulate economic growth through investment in sustainable activities that protect natural capital[1]- a topic that continues to spark debate across Australia.

While regulation drafted under the The Sustainable Finance Action Plan will be mandatory for many entities operating within the EU, Australian companies seeking investment from the EU, or looking to sell or broaden their markets across EU-countries, may find they need or want to comply. The regulations are broad in their scope, and stringent in their requirements. Corporates, asset managers, pension funds, banks, insurers and others will have substantial and comparable information being disclosed as a result, allowing sustainability efforts to be evaluated like-for-like.

1 European Commission - European Commission. (n.d.). Overview of sustainable finance. [online]

Regulatory instruments that are relevant

Sustainable Finance Disclosure Regulation (SFDR)

The scope of SFDR captures financial market participants, such as investment managers and financial advisors, that actively market their products (e.g., funds) in Europe. The SFDR was introduced by the European Commission alongside the Taxonomy Regulation and the Low Carbon Benchmarks Regulation as part of a package of legislative measures arising from the European Commission's Action Plan on Sustainable Finance. Among a broad range of impact, most significantly, the regulations require products to be classified as 'light green', 'dark green', or 'grey' - corresponding to the role that ESG has in the product's promotion, investment strategy and purpose - with varying levels of associated disclosure. This standardised product labelling will allow investors to better compare, assess, and select investments with respect to ESG, going some way to address a long-standing issue that comparability with respect to ESG is incredibly challenging.

EU Taxonomy

The Taxonomy Regulation is the EU Commission's landmark piece of regulation that aims to tackle 'greenwashing' - an act whereby companies intentionally and falsely disclose and/or market misleading information regarding the extent to which they protect or support the environment. The Taxonomy does this by specifying the exact criteria that must be met in order to determine whether an activity is environmentally sustainable, including whether the activity contributes to one or more the six environmental objectives [2].The Taxonomy Regulation takes effect 1 January 2022 and extends to public interest entities required to prepare a non-financial statement under the Non-Financial Reporting Directive, as well as issuers[3] of products that, under SFDR, have been labeled 'light green' and 'dark green'.

Green Bond Standard

Those issuing an EU Green Bond can voluntarily adopt the GBS involving - among other things - must classify the economic activities financed by the bond in accordance with the EU Taxonomy.

Non-financial reporting directive (NFRD)[4]

(To be expanded and renamed Corporate Sustainability Reporting Directive (CSRD)

All large listed companies, banks and insurers, must report whether - and to what extent - their or their investee companies' activities make a substantial contribution to any of the environmental objectives listed under the Taxonomy Regulation [5].The CSRD expands the scope of the NFRD, from approximately 11,000 entities to 49,000 entities when it comes into force by the end of 2022 (covering 2023 financial reports) [6].

Key ESG regulatory timings for the EU

From 10 March 2021
Sustainable Finance Disclosure Regulation (SFDR)

Late 2021
Green Bonds Standard (GBS) [proposal]

From 1 January 2022
EU Taxonomy

2 The six environmental objectives as defined in the proposed Regulation are: (1) climate change mitigation; (2) climate change adaptation; (3) sustainable use and protection of water and marine resources; (4) transition to a circular economy, waste prevention and recycling; (5) pollution prevention and control; (6) protection of healthy ecosystems.

3 EU PIEs are also impacted by the Taxonomy, but they are not expected to exist among PwC's Australian client based

4 to be expanded and renamed Corporate Sustainability Reporting Directive (CSRD)

5 Taxonomy reporting under the Non-Financial Reporting Directive [online]

6 Questions and Answers: Corporate Sustainability Reporting Directive proposal [Source]

Key components of the EU's 2018 Sustainable Finance Action Plan

The following table further highlights critical components of the deal. At present, only the SFDR is mandated, and requires high level disclosures to be made as of 10 March 2021. The Taxonomy Regulation and more detailed disclosure rules don't come into effect until 1 January 2022. Overall, a key objective of the SFAP is reorienting capital flows towards a more sustainable economy. While the speed at which this outcome will be achieved is unknown, in a recent PwC survey of European institutional investors, 75% of survey respondents indicated they planed to stop buying European non-ESG products within the next two years[7].

	SFDR	EU Taxonomy	GBS	NFRD / CSRD
Goal	Clarifying institutional investors' and asset managers' duties	Establishing an EU classification system for sustainable activities	Creating standards and labels for green financial products	Strengthening sustainability disclosure and accounting rule-making
Scope	Financial market participants and financial advisors, and their products marketed in the EU	Financial market participants and financial advisors, and their products marketed in the EU, as well as large public interest entities	Issuers of EU Green Bond Standard financial instruments.	Large listed companies and banks and insurers. Proposed CSRD would expand to include all large *and* listed companies[8]
Criteria/ requirements	Disclosure of how sustainability risk is considered in investment decision making, as well labelling products as light green, dark green, or neutral, both in pre-contractual and periodical reports	Disclosure of the extent to which the economic activities of an entity (either as the entity themselves or as an investor in such an entity) are 'Taxonomy aligned' and therefore environmentally sustainable	Under the proposal, disclosure will be required of how financed green investments align to the EU taxonomy, and transparency on the use of proceeds with verification	Under the proposal, expansive disclosure covering an entity's business model and strategy, targets and policies relating to 'sustainability matters' - among other areas - and must be assured. EFRAG will develop the standards, and must be consistent with SFDR and EU Taxonomy
Timelines	Disclosures from 10 March 2021 (with additional deadlines from 2022 onwards)	Disclosures from 1 January 2022*	TBA	Disclosures expected from 2024, covering financial year 2023

*The Taxonomy, while only partly complete, currently focuses on environmental objectives - but this may change over time to become a social, as well as environmental, taxonomy.

Dark green

Financial product with a sustainable investment objective

Light green

Financial product that promotes among other characteristics, environmental or social characteristics (provided the investee companies follow good governance practices)

Grey

May or may not consider ESG factors but, if considered, are not bound to do so.

The regulatory changes are aimed at improving the transparency around investments for retail and institutional investors alike, shifting the dial to a more greener and sustainable EU. In July 2021, the EU released a new Sustainable Finance Strategy. This strategy builds on the initial sustainable finance strategy, but looks to further enhance it - including, for example, expanding the taxonomy further to cover transition activities, support social investments through a social taxonomy and indicators, define and support green retail products (such as green mortgages), and consider financial reporting standards can capture relevant sustainability risks.

7 Asset and wealth management revolution: The power to shape the future. [Source]
8 Questions and Answers: Corporate Sustainability Reporting Directive proposal [Source]

How do European regulations impact Australian organisations?

Whether companies have financial products or operations in Europe only partly determines the impact of these regulations to their business. The EU is the second largest investor in Australia[9], therefore, as companies have European investors, they will feel the impact of these regulatory changes.

Changes may include data request from clients and analysts, to critical investors considering re-allocation of their capital to more ‘green’ investments. Concern around how these regulations will shape investment in Australia has already been felt by certain industry groups, notably, the Minerals Council of Australia[10].

The apprehension felt by companies towards this regulation may also be a function of the fact that other jurisdictions - notably China[11] and Singapore[12] - are considering implementation of similar (if not identical) regulations.

The spectrum of impact for Australian companies may include:

	No impact	Low impact	Medium impact	High impact
Operations	Autralian asset manager or entity (financial or corporate)	Autralian asset manager or entity (financial or corporate)	Autralian asset manager or entity (financial or corporate)	Autralian asset manager or entity (financial or corporate)
Capital (in context of EU)	All ex-Europe	Minimal EU capital, all passive	Significant EU capital, all passive	Actively capital raising in EU through fund marketing of green bond issuance
Next steps	Watch how other jurisdictions respond	Be aware, and know how to respond to, data requests	Prepare for data requests, and consider data gap analysisis	You are regulated - prepare disclosures

All companies should consider how Sustainable Finance, and regulations like it, will impact direction of capital to their business

9 Australian Government Department of Foreign Affairs and Trade. (2018). Statistics on who invests in Australia. [online]
10 The Guardian. (2021). Australia’s miners urge Europe to define nuclear power and fossil fuels with carbon capture as “sustainable.” [online]
11 Financial Times. Li, S. and Yu, R. (2021). China reveals cooperation with EU on green investment standards. [online]
12 Allen & Overy, Kwok, S., Robins, C. and Lim, W.T. (2021). Singapore consults on a taxonomy for the financing of environmentally sustainable activities [online]

A new global trend?

Major territories including the UK[13], China, and Singapore are discussing similar proposals (notably, potential taxonomies) to the EU. In Australia, AFSI has flagged development of a sustainable finance taxonomy. However, when and if such a framework would be adopted in Australia remains uncertain, as well as whether government support would exist for mandatory adoption.

Considerations for Australian executives

Depending on your market position, there are five key areas of consideration given the activity and changes in the EU, these are:

1. Do you have critical European capital invested in your company?
   Next step: Start the conversation to understand the status of their Taxonomy/SFDR journey and impacts to their plans to continue allocating capital to your business

2. Does your business currently report ESG information that would meet global standards
   Next step: Consider future data needs that are being driven by local and global regulations, as well as strategic reporting benefits.

3. Do you have clarity on which capital markets you want to access in the next 1-5 years?
   Next step: Consider how the markets you access will react to your ESG agenda (or lack of).

4. Overall, where is ESG on your Board's and industry's agenda?
   Next step: Connect to industry conversations on ESG to ensure your Board is having the right dialogue on ESG.

5. For asset managers only, do you have products that are marketed in the EU?
   Next step: Understand the disclosure requirements for your products in scope.

> "The EU green deal is a new growth strategy that aims to transform the EU into a fair and prosperous society, with a modern, resource-efficient and competitive economy where there are no net emissions of greenhouse gases in 2050 and where economic growth is decoupled from resource use."
>
> EU Commission

13 https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services

In summary

The EU intent is clear: give the economy a direction for where future investments should be made. The bloc's leading role in this space should not be seen as an outlier, but rather, as a leader and indicator of where global regulation is heading. Their approach and model is one that other countries and regions are likely to follow, and Australian businesses, regardless of sector, will be impacted. Ready or not, Australia will feel the changes that global policy makers are collectively making in response to a growing awareness of the urgency to address greenhouse gas emission and climate change.

If you would benefit from a more in-depth conversation regarding the EU Green deal and its possible implications for your organisation, please contact one of our deep ESG experts below.

Sam King-Jayawardana
ESG Director

sam.a.king-jayawardana@pwc.com

John Tomac
Sustainability leader

john.tomac@pwc.com

Alfredo Martinez
Partner, Capital Markets

alfredo.martinez@pwc.com

pwc

127081891