Transparency on Sustainable Finance by the financial services sector – impact on strategy and operating model

Overview and how we can be of help

Introduction

- For the financial services sector much is about to change with respect to sustainability in 2021. Increased transparency and capabilities are required, impacting strategies and asking for business transformation.
- In this brochure we have summarized the main elements and connectivity of the EU Taxonomy, SFDR, NFRD and GBS.
- The financial sector is seen as a critical enabler of the transition towards sustainable growth. The European Commission (EC) developed an Action Plan on Financing Sustainable Growth. The *EU Taxonomy (Taxonomy)* Regulation is part of this. In essence, it regulates a dictionary to determine what type of economic activities are actually sustainable - including related thresholds, referred to as Technical Screening Criteria (TSC) and will be used throughout the EU Action Plan (see picture right side). It replaces the myriads of current sustainability definitions.
- The EC started defining the TSC for six environmental objectives at both sector and economic activity level. Currently, the TSC for Climate Change Mitigation (CCM) and Climate Change Adaptation (CCA) are most advanced and are regulated through a delegated act as per December 2020. The development of the TSC is an ongoing progress. The TSC on the other four environmental objectives is anticipated to be ready by December 2021 (postponed till further notice), comprising water, circular economy, pollution and biodiversity). A uniform Taxonomy should help Financial Market Participants (FMP) and advisors assess to identify the extent to which the sustainable financial products they offer or advice on (art. 8 and art. 9 SFDR) are aligned with environmentally sustainable economic activities as described in the available and regulated TSC.
- The *EU Sustainable Finance Disclosure Regulation (SFDR)* has entered into force and has different types of disclosure requirements depending on the type of investment products, as well as for the entity as a whole, starting from March 2021 (see next page for a timeline). Disclosures relate to various perspectives: sustainability risks on the value of the investment, principal adverse impacts of the investment product on sustainability and contributing to sustainability. The three European Supervisory Authorities will jointly issue the regulatory technical standards (RTS).
- With respect to finance, a voluntary *Green Bond Standard (GBS)* will be applicable, to be used if financial institutions want to indicate their 'Green Bonds' as Taxonomy-aligned.
- In the Netherlands the Dutch financial sector committed itself to comply with the Dutch Climate Agreement. The applicable financial institutions will report on the climate impact of loans and investments from FY 2020. By 2022 at the latest, they will publish their action plans, disclosing their contribution to the reduction of CO2 emissions.

EU Taxonomy – uniform interpretation of sustainability

Economic activities will need to comply with the following three elements to be considered sustainable under the Taxonomy:

1. Substantially contribute to at least one of the six environmental objectives as defined in the Regulation through the TSC;
2. Do No Significant Harm (DNSH) to any of the other five environmental objectives as defined in the Regulation through TSC; and
3. Comply with minimum social safeguards.

Taxonomy-alignment in European legislation

Taxonomy regulation additions in existing regulation for SFDR and NFRD

Taxonomy references in upcoming legislation for Green Bonds, Sustainability Benchmarks, Labelling Green Products etc.

SFDR

- Transparency on ESG at entity level and product level on website, brochure, periodic reporting
- Entity-level disclosures: Sustainability risk policies, consideration of principal adverse sustainability impacts at entity level, sustainability in remuneration policies
- Product-level disclosures: Integration of sustainability risks in investment decisions and/or investment/insurance advice, likely impact of sustainability risks on financial return product, consideration of adverse impacts on sustainability factors of the product
- Products that promote environmental or social characteristics additionally: how those characteristics are met, whether and how an index is used
- Products with a sustainable objective additionally: the overall sustainability-related impact of the financial product by means of relevant sustainability indicators, how a designated index is aligned with that objective and how it differs from abroad market index or if no index, how the objective is attained
- Additional Taxonomy implications*:
  - For SFDR art. 8 and art. 9 products proportion of investments in the Taxonomy-aligned environmentally sustainable economic activities.
  - Cautionary statement related to DNSH

NFRD

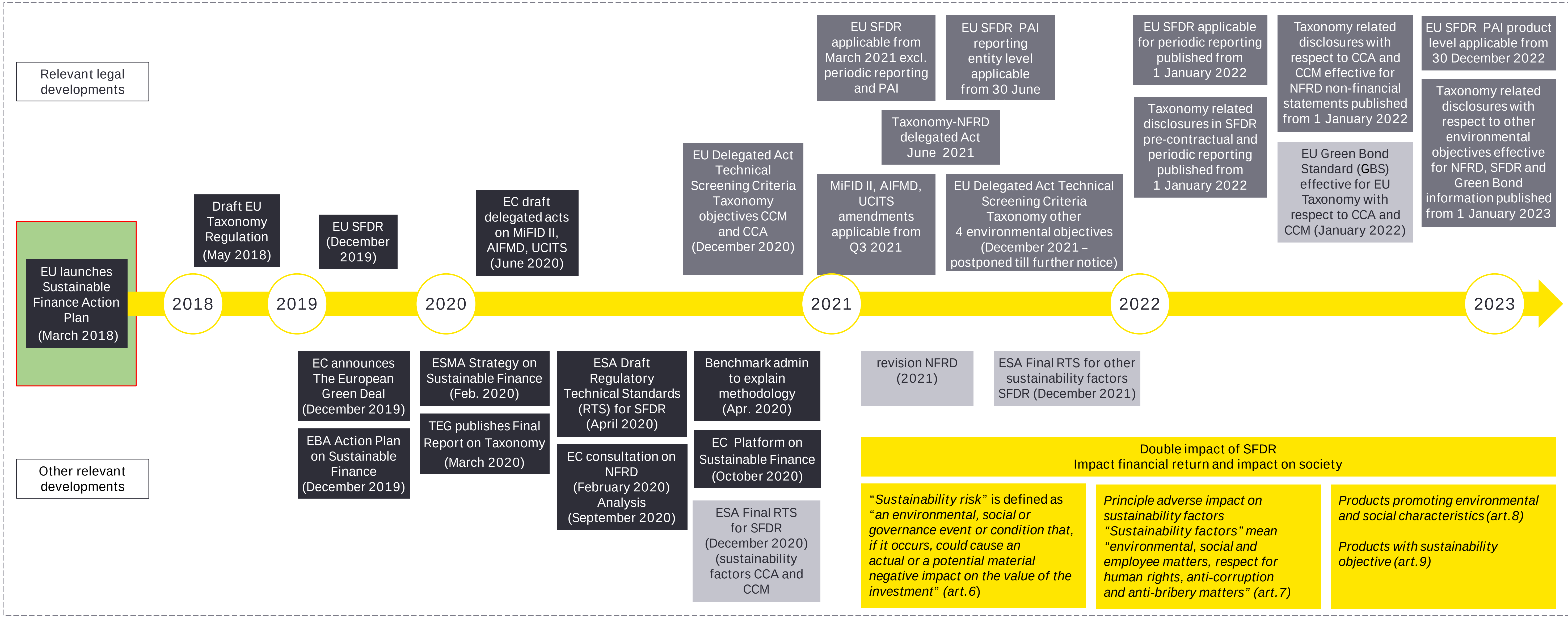
- Transparency on ESG at entity level in NFI statement in annual report
- Additional Taxonomy implications*:
  1. How and to what extent the undertaking's activities are associated with economic activities that qualify as environmentally sustainable
  2. In particular, non-financial undertakings to disclose Taxonomy-aligned proportion of:
     a) Turnover/revenue
     b) CapEx
     c) OpEx
  3. Asset managers required to report under NFRD should disclose the ratio of eligible investments that are Taxonomy-aligned per ESMA draft advice to EU

GBS

- Transparency at product level
- Process:
  1. Aligning the GBS' green criteria against the Taxonomy*
  2. Publish a Green Bond Framework containing Taxonomy-aligned information and methodology used
  3. Issue an Allocation and Impact report and
  4. Engage an accredited external verifier for the reporting disclosures.

** The grey areas above mention the connectivity to the EU Taxonomy regulation*

What is the expected timeline? How will this impact your organization?



Organizational Impact: The regulatory developments have an organizational impact, not only from a risk perspective, but also from an opportunity perspective. It impacts in various ways asset managers, pension funds, insurance companies, banks, real estate fund managers, as well as public interest entities with over 500 employees.

Strategy and policy opportunities: The Taxonomy provides an opportunity to demonstrate in a harmonized way your roadmap towards a more sustainable portfolio that creates value to your organization as well as to society at large. Depending on your ambition you may want to set targets for this roadmap, using science-based target setting. Redefining your strategy also has implications for the underlying policies and actions. Achieving more ambitious sustainability strategies also has implications for your governance structures, that should be consistent with your ambitions in the area of sustainability. Also embedding sustainability in your stakeholder engagement, including with investors, will help you to keep abreast of stakeholder expectations in the area of sustainability.

Products and services: With these new developments you may want to align your product and service portfolio more to sustainability profiling (for example, ESG funds, green bonds, green loans), as well to assess the sustainability risk for your current portfolio. And conclude what this mean for your end to end customer value chain procedures and proposition.

Risk management: You may need to embed sustainability risks into your risk management system from identification to reporting, use scenario analyses and stress testing as important instruments, consider from an inside-out and inside-out perspective the potential sustainability risks, use multiple time-horizons depending on the kind of sustainability risk, consider both physical risks as well as transition risks.

Management reporting and external reporting: Your reporting processes need to be aligned with the revised organization's strategy and ambitions, enabling compliance with NFRD and SFDR requirements and other commitments such as TCFD and PRI reporting. You may want to assess whether your KPIs are still the most relevant KPIs. Since the information on sustainability becomes more important to economic decision making you may also want to reassess whether your reporting process are robust enough to deliver high quality information that is comparable, both on a product level as well as on an entity level.

Your contribution at C-level: The developments impact your role in the C-suite of the organization. As a CEO it provides a challenge to define the sustainability ambition of your organization, your strategy, policies and innovation in your products and services to address not only future risk, but to also be able to use the opportunities for more demand for sustainable investments and finance.

As a chief (financial) risk officer (CRO) you will be involved in embedding sustainability in existing risk management systems, define the kind of data you need to effectively manage risks and report on progress internally as well as through external reporting, both at an entity level as well as on a product level.

As a chief operating officer (CFO) you will be involved in the impact of the organization on the operational processes of the organization, including ensuring that there is sufficient competence to respond to these new challenges.

Changing capabilities and business transformation:

All the above will result in changing capabilities and a business transformation.

Detailed mapping

When?	Legislation	What to disclose?	Whom	Level	Where
10-03-2021	SFDR (art.3)	Policies on the integration of sustainability risks in investment decision-making process or investment/insurance advice	FMPs, FAs	Entity	Website
	SFDR (art.4)	Consider principal adverse impacts (PAI) of investment decisions/investment advice/insurance advice on sustainability factors (art 4.3) Statement on due diligence policies with respect to PAI: always applicable for FMP>500 – 30 June 2021	FMPs, FAs comply or explain	Entity	Website
	SFDR (art.5)	In remuneration policies how those policies are consistent with the integration of sustainability risks	FMPs, FAs	Entity	Website
	SFDR (art. 6)	Transparency of the integration of sustainability risks (1) Manner in which sustainability risks are integrated in investment decisions/advice and (2) Likely impacts of sustainability risks on the returns of financial products (basic article, supplemented by art. 7, and if applicable art. 8 or 9)	FMPs, FAs comply or explain	Product	Pre-contractual disclosures
30-12-2022	SFDR (art.7)	Transparency of adverse sustainability impacts of investment decisions on sustainability factors at financial product level (supplements art. 6 and references entity level art. 3 disclosure on website) (a) Explanation of whether and how a financial product considers principal adverse impacts on sustainability factors (b) Statement that above related information or an explanation if FMP did not consider the adverse impacts	FMPs comply or explain, always applicable for FMPs >500 employees	Product	Pre-contractual disclosures
10-3-2021	SFDR (art.8)	Transparency of the promotion of environmental or social characteristics (a) Products that promote these characteristics, information on how those characteristics are met (ESA RTS to describe these characteristics); (b) If an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics and an indication of where the methodology used for the calculation of the index can be found.	FMPs, FAs	Product	Pre-contractual disclosures
10-3-2021	SFDR (art.9)	Transparency of sustainable investments (products with a sustainable objective) on how the sustainability performance is measured (a) How the designated index is aligned with the objective of the product and how it differs from a broad market index or (b) If no index is used how the objective is attained	FMPs, FAs	Product	Pre-contractual disclosures
10-3-2021	SFDR (art.10)	Transparency of the promotion of environmental or social characteristics and of sustainable investments (a) For each art. 8 or art. 9 product the environmental or social characteristics or the sustainable investment objective (b) Information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product (c) The information referred to in pre-contractual information on ESG promotion and ESG investment; (d) The information in periodic reports on ESG promotion and ESG investment.	FMPs that offer art.8 or art.9 products	Product	Website
01-01-2022 (FY 2021)	SFDR (art.11)	Transparency of the promotion of environmental or social characteristics and of sustainable investments (a) For a art. 8 financial product: the extent to which environmental or social characteristics are met; (b) For a art. 9 financial product: (i) the overall sustainability-related impact of the financial product by means of relevant sustainability indicators; or (ii) where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators.	FMPs that offer art.8 or art.9 products	Product	Periodic reporting (annual report)
01-01-2022 (FY 2021)	Taxonomy (art. 5, 6 and 7) leading to additional requirements for SFDR	For SFDR art. 8 and art. 9 products the proportion of investments in Taxonomy aligned environmentally sustainable economic activities selected for the financial product, including details on the proportions of enabling and transitional activities as a percentage of all investments selected for the financial product. For SFDR art. 8 products a cautionary statement 'The "do no significant harm" principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities'. For products with no ESG component cautionary statement 'The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.'	FMPs	Product	Pre-contractual and periodic reports
01-01-2022 (FY 2021)	Taxonomy (art. 8) leading to additional requirements for NFRD	For companies in scope of NFRD it should disclose on its non-financial statement how and to what extent the undertaking's activities are Taxonomy aligned environmentally sustainable economic activities (a) the proportion of their turnover derived from products or services associated with economic activities that qualify as environmentally sustainable (b) the proportion of their capital expenditure and the proportion of their operating expenditure related to assets or processes associated with economic activities that qualify as environmentally sustainable.	Companies in scope of NFRD	Entity	Non-financial statement or separate report

01

Impact regulation assessment

In this fast changing regulatory environment it is of importance not only to be compliant, but also to anticipate on upcoming legislation. A pro-active attitude will help you define your own roadmap in line with legislation rather than facing surprises leading to reactive responses. EY has an ESG tool that helps you navigate through the regulatory landscape and identify how new and revisions to existing legislation may impact your organization as financial market participant. EY can also help you explore relevant external developments in your sector, how your peers are performing and help you identify relevant stakeholder expectations. This will support you on focusing on the matters that are most relevant in this fast changing environment.

02

Redefine strategies and policies regarding sustainability

The rapidly changing regulatory landscape and stakeholder expectations may also result in a willingness to redefine your ambition, strategy and policies with respect to sustainability. This includes not only responding to potential compliance, physical or transition risks, but also pro-actively seeking opportunities to contribute to a more sustainable society through the lens of finance. Redefining this consistently throughout your organization will help you benefit from the upcoming legislation that sets much more detailed requirements at an activity and product level. EY can support you with redefining your strategy and policies throughout your organization. The approach is Now, Next and Beyond.

03

Gap analysis on operating model and implement operating model changes

We can help you map the future state you have in mind against the existing situation, for example with respect to policies, operationalizing policies, risk management, performance indicators, reporting processes and internal controls. We can help you identify the gaps and provide you with suggestions for improvement and support in implementing operating model changes. For example, how you can demonstrate a robust verifiable process for identifying the most material topics in this fast changing environment, setting (science-based) targets, identifying relevant performance indicators and measuring them in a consistent way.

04

Reporting

The new and upcoming legislation also has implications for the content of your annual report and the financial statements. We can help you identify what you need to disclose in your annual reporting, other periodic reporting, on your website and if applicable in pre-contractual brochures. Next we can help you to report this in a transparent and high quality manner. We can help you with ensuring a robust audit trail for the content of your reporting in the annual report, on your website or pre-contractual information.

5A

Assurance readiness check

You can enhance the credibility of the information through external assurance. An assurance readiness assessment brings you internal benefits. It will help you to obtain insight in the quality and verifiability of your reporting process, your stakeholder engagement processes, the data systems, your KPIs and your internal controls. Points of improvement are identified and discussed with you. In this way you can build a robust and verifiable reporting process. This enables that any future assurance engagements can be performed more effectively. It also offers the possibility to critically review the chosen criteria for KPIs.

5B

Assurance

The demand for credible information is increasing and as a result we see more demand for assurance. We can perform an assurance engagement on different types of subject matters. Most common are assurance engagements on the reported information. However, assurance engagements can also be performed on systems and processes or compliance with particular policies, such as compliance of investments made with your investment policy. An assurance engagement can be aimed at obtaining reasonable assurance or limited assurance. In a limited assurance engagement the nature, timing and extent of procedures is less than in a reasonable assurance engagement. The subject matter, the criteria for evaluating the subject matter and the level of assurance will depend on legislation, if any, stakeholder expectations and your needs.

Our 5-step approach to support you with future-proof ESG compliance
(the biggest added value is the full package but each step can be performed in isolation)

01	02	03	04	05
Impact regulation assessment using EY ESG tool	Redefine strategies and policies regarding sustainability *Now Next & Beyond*	Gap analysis on operating model and implement operating model changes	Reporting	Assurance readiness check/assurance

For questions, please contact us:

Jan Niewold
Partner
Climate Change and Sustainability Services
+31 6 2125 1664
jan.niewold@nl.ey.com

Remco Bleijs
Associate Partner
Head of Sustainable Finance Netherlands
+31 6 2908 3118
remco.bleijs@nl.ey.com

Erik Wedershoven
Senior Manager
Climate Change and Sustainability Services
+31 6 21 25 2674
erik.wedershoven@nl.ey.com

Annebeth Roor
Advisor
Climate Change and Sustainability Services
+31 6 29 08 41 01
annebeth.roor@nl.ey.com

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