Sustainable Finance and the Non-Financial Reporting Directive

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By Francesca Maria Vidori

I/ Introduction – The European Green Deal

Since 2018, the European Union (EU) has been exploring ways to integrate sustainability in its policy framework with an ambitious target is to become climate neutral by 2050.[1] In order to reach this target, several actions will have to be implemented, such as supporting industry innovation and working multilaterally with international partners to improve global environmental standards.

II/ Sustainable Finance

The Sustainable Finance Package, as a integral part of the European Green Deal aims at combining the financial policy framework with Environmental Social and Corporate Governance (ESG) standards. This is performed by channeling private investment into the transition to a climate-neutral, climate-resilient, resource-efficient and just economy. Sustainable Finance will also help ensure that investments support a resilient economy and a sustainable recovery from the impacts of the COVID-19 pandemic.

The final report of the High-Level Expert Group on Sustainable Finance outlined a lack of long-term perspective, transparency and sustainability in financial markets.[2]

To bridge this gap, the European Commission has developed an EU Action Plan for Sustainable Finance, with the support of a Technical expert group on sustainable finance (TEG).[3]

In order to mobilize finance towards sustainable growth the European Commission developed a legislative proposal in May 2018 that consists of the following:[4]

- **EU taxonomy for sustainable activities**

[1] https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

[2] https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

[3] https://home.kpmg/fi/fi/home/Pinnalla/2019/07/eu-sustainable-finance-explained-part-i-overview.html
https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en#disclosures

[4] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/what-sustainable-finance_en

An EU classification system for sustainable activities to determine if a business or economic activity is environmentally sustainable.

- **EU Green Bond Standard**
  To enhance effectiveness, transparency, comparability & credibility of green bond market & encourage market participants to issue & invest in EU green bonds
- **Corporate disclosure of climate-related information**
  Provides guidance for companies on how to report on the impacts of their business on the climate and on the impacts of climate change on their business.
- **EU climate benchmarks and benchmarks' ESG disclosures**
  To enhance the ESG transparency of benchmark methodologies and to put forward standards for the methodology of low-carbon benchmarks in the Union.
- **Sustainability-related disclosure in the financial services sector**
  Sustainability disclosure obligations for manufacturers of financial products and financial advisers toward end-investors.
- **International platform on sustainable finance**
  The ultimate objective of the IPSF is to scale up the mobilisation of private capital towards environmentally sustainable investments.

Of great relevance is the section on **Corporate disclosure of climate-related information**, as it is consistent with the requirements of the **Non-Financial Reporting Directive (NFRD).**[5]

The aim of this Directive is to provide guidance for companies on how to report on the impacts of their business on the climate and on the impacts of climate change on their business.

III/ Non-Financial Reporting Directive

This Directive was published in 2017 and is requires large listed companies, banks and insurance companies with more than 500 employees to disclose non-financial information on their environmental and social impacts.[6]

This implies that financial institutions will have to take sustainability into account in their strategies, risk management and reporting.

The Directive gives companies significant flexibility to disclose relevant information. Companies may use international, European or national guidelines to produce their statements, such as the UN Global Compact, the OECD guidelines for multinational enterprises, ISO 26000.

This is done with the goal of allowing the investment community, consumers, and other stakeholders to take into account non-financial performance when investing, encouraging the companies to implement a more long-term oriented and sustainable approach to their activities.

However, the underlying problem encountered consists of:

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5 https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en

6 https://www.iflr.com/article/b1mqz23jghv4pp/primer-the-eus-green-finance-rules
https://www.cdsb.net/eu-non-financial-reporting-directive/1029/eu-green-deal-and-nfrd-review-will-eu-manage-turn

- a lack of consistent and comparable environmental-related information in implementing the Directive.
- companies incurring unnecessary costs related to unnecessary non-financial reporting

Despite these limitations it is important that companies improve their disclosure of non-financial information.

With this purpose, the Commission pledged to review the NFRD by **Q1 of 2021**. The initial step to review the Directive is through a public consultation on its inception impact assessment.[7]

The three high level policy options are the following:

- Continue with the current approach, based on voluntary and non-binding guidelines;
- Explore the further use of standards; and
- Revise and strengthen the provisions of the NFRD.

The majority of the responses to the public consultations agreed with the third point as a way to

- include non-financial information in the management report, to better link financial and non-financial information;
- Include a larger scope of application with more companies covered by the Directive's requirements;
- clarify the definition of materiality.

While facilitating the disclosure of consistent and comparable sustainability information is fundamental for investors' decisions, excessive and overburdensome standardization may not consider the differences across various sectors of the economy and may result in costly compliance for

[7] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive

companies. Ideally, within-sectors standardization can be applied in regard to specific types of information (KPIs), leaving companies adequate room of maneuver to decide what they want to report in terms of their mission and business strategy.[8]

For what concerns the scope of the directive, lowering this threshold of 500 employees could imply further compliance measures for smaller companies. Nevertheless, the review of the NFRD can generate opportunities for simplification and reductions of administrative burden.

One suggestion could be to link the compliance requirements not only to the size of the company, but also to a risk assessment of the company's activity, so as to efficiently target reporting requirements to the industries representing a higher risk.

IV/ Conclusions

The trend of sustainable finance is widely spreading and cannot be reversed. Investors are now looking for sustainability metrics in companies they invest in. Thus, it is in the interest of companies to clearly outline what the reporting frameworks are, in order to have cost-effective and comparable reporting standards.

[8] https://www.euractiv.com/section/energy-environment/interview/eu-green-finance-czar-obvious-that-companies-should-report-on-climate-risk/