Seven Observations From the EU Sustainable Finance Regulation - Perspectives From a Dutch Asset Manager

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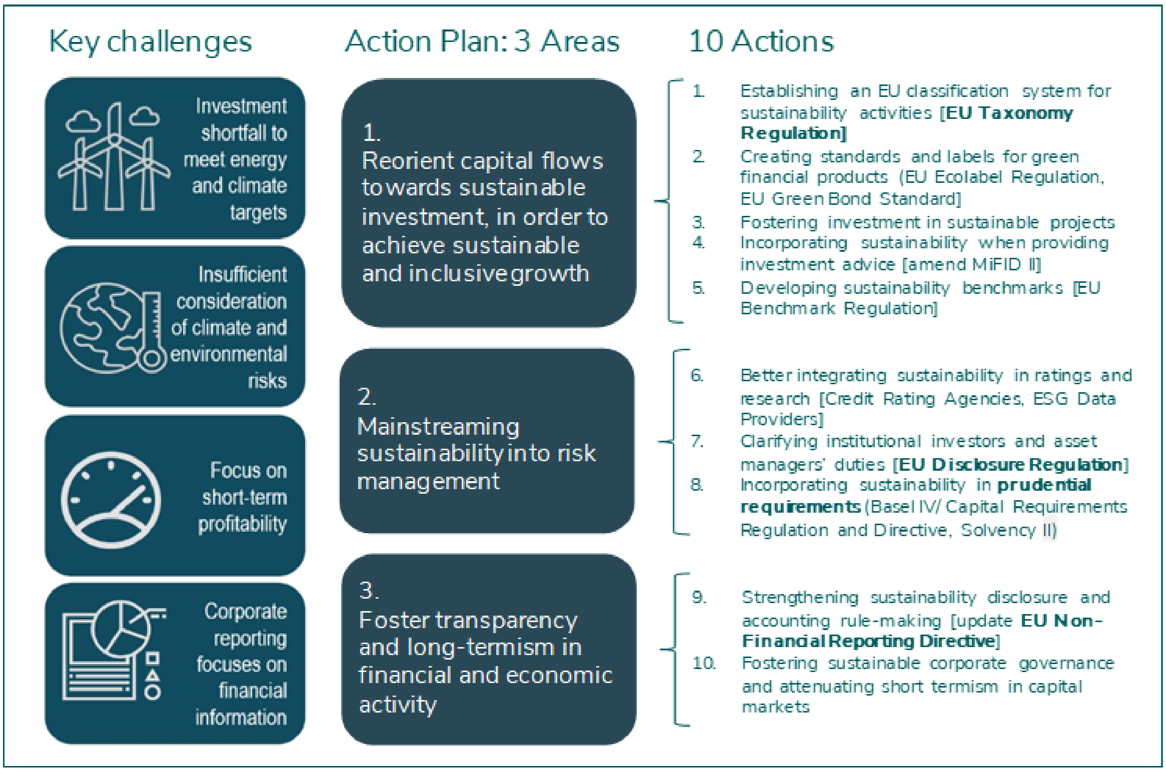
Over the past couple of months, we at wealth management specialist Van Lanschot Kempen have undertaken a considerable amount of work mapping the requirements of the EU Sustainable Finance Regulation to our activities and solutions. In this contribution, we share some of our observations linked to how it impacts our asset management business, Kempen Capital Management.

Europe remains committed

Two years ago, the European Union (EU) embarked upon a major transition towards a lower carbon future, building on the recommendation of the High-level expert group on sustainable finance. This was formulated in its **Action Plan 'Financing Sustainable Growth'**, underpinning Europe's goal to become climate neutral by 2050. For Europe, "the transition to a low-carbon, more sustainable, resource-efficient and circular economy in line with the UN Sustainable Development Goals (SDGs) is key to ensuring long-term competitiveness of the economy of the Union"[1]. Although various details of the package of measures have not yet been finalised, the direction of travel is loud and clear. Despite Brexit and the pandemic, the EU remains committed to its ambition. Much needs to be addressed in order to realise this ambition. This ranges from accelerating the investments required for the transition, to creating better awareness of sustainability risks, and improving the reporting of sustainability (currently called 'non-financial' in the EU regulation) information (see the figure below).

Figure 1: Overview EU Sustainable Finance Action Plan



Source: European Commission, 8 March 2018, Action Plan: Financing Sustainable Growth

[1] EU Disclosure Regulation 2019 2088, 27 November 2019

The Sustainable Finance Action Plan in turn fits into the even broader European Green Deal, announced in December 2019. The European Commission (EC) has initiated an ambitious multi-dimensional programme, where all the elements are intended to fit together like clockwork.

The EU Non-Financial Reporting Directive is the bedrock

One of the first actions on the regulatory front - and embedded in law - has been the formation of the **EU Non-Financial Reporting Directive** (NFRD)[2] which came into effect in all EU member states in 2016. The NFRD deals with the disclosure of sustainability and diversity information. It applies to large companies with more than 500 employees (listed companies, banks, and insurance companies), thereby covering approximately 6,000 large companies and groups across the EU. These companies are required to include 'non-financial statements' in their annual reports in which they report on their business model, management of environmental protections, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery, and board diversity.

Despite the good intentions, the broad consensus is that the NFRD in its current form is not perfect. There is too much discretion for companies in selecting the information they want to disclose. As a result, some companies are failing to report relevant information in the first place; a great deal of the information that is disclosed is not particularly decision-useful for the investment community and other stakeholders; the information reported is often not acceptably reliable or comparable; and in addition, can be hard to find. Moreover, since there is no commonly agreed sustainability reporting framework, companies may use different international, European or even national guidelines that are principle-based or rule-based to produce their statements as they deem fit. In 2019 the EC released the non-binding Guidelines on reporting climate-related information, which aims to align NFRD-reporting with the TCFD Recommendations. This may help drive more aligned reporting across the EU somewhat, but a stronger measure has been called for by many stakeholders.[3]

And getting a makeover

To meet the objectives of the **European Green Deal**, at least €1 trillion in sustainable investments are needed over the next decade alone. The bulk of this needs to come from the private sector. Robust, relevant and trustworthy sustainability information from investee companies is essential to support these capital flows. Admittedly, with Europe wanting to strengthen the foundations for sustainable investment, the NFRD is in need of a makeover. In fact, some (forthcoming) EU sustainability regulations, such as the EU Taxonomy Regulation[4] and the EU Disclosure Regulation[5], can only fully meet their objectives if more focused and better structured sustainability information is available from investee companies as recognised by the European Commission itself.[6] Acknowledging this, the European Commission entered into a consultation for a review of the NFRD. It is expected to publish draft legislation to give effect to the changes in Q4 of this year.

Our seven observations

In the remainder of this contribution, we share some of our initial observations, having looked at the ramifications of two key regulatory pieces, the EU Taxonomy Regulation and the EU Disclosure Regulation.

The **EU Taxonomy Regulation** is about introducing harmonised criteria to determine whether a particular economic activity is environmentally sustainable and is thereby addressing greenwashing. The goal is for investors to better understand the degree and proportion of environmental sustainability in their

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[2] EU Directive 2014/95/EU

[3] See https://ec.europa.eu/finance/docs/policy/190618-climate-related-information-reporting-guidelines_en.pdf and https://www.fsb-tcfd.org/publications/final-recommendations-report/

[4] EU Taxonomy Regulation (Proposal) 2018 0178, 17 December 2019

[5] EU Disclosure Regulation 2019 2088, 27 November 2019

[6] European Commission, Public consultation on the revision of the nonfinancial reporting directive, February 2020

investments. Under the EU Taxonomy Regulation, companies that are under the scope of the NFRD are required to disclose certain indicators of the proportion of their activities that are classified as sustainable according to the taxonomy. The viewpoint of a particular economic activity rather than a sector is different from how the asset management industry traditionally looks at clustering its exposure. Essentially, under the EU Taxonomy Regulation what matters is how a company is positioned in a cluster of green and non-green activities, merely than it being part of a broad sector or industry group. Much of the issuer data is not organised as such, which poses a challenge.

The EU Disclosure Regulation aims to provide a level playing field by implementing rules for financial intermediaries on transparency at both entity and product level with regard to sustainability risks, adverse sustainability impacts and the provision of sustainability-related information in their communication with their end clients. As such, the EU Disclosure Regulation also focuses on combating greenwashing. Effectively, it is there to show the negative impact investments have on environmental and social factors and to hold financial intermediaries that promote sustainable characteristics of their funds to a greater account on what has actually been achieved in practice.

Both regulations are relevant at different levels, the product level, entity level and listed company level. There are additional measures, such as the EU Benchmark regulation (focusing on the decarbonisation trend in investments over time, but with a more limited target audience) and the EU Eco label regulation, but both fall out of scope for this review.

1. An opportunity for Europe and for its finance sector

The current and forthcoming regulation is part of an ambitious agenda in which Europe wants to build a low-carbon economy that is both competitive and climate neutral, in other words future fit. We would argue that Europe is at the forefront in this. Yes, there are other initiatives, for example in Asia – particularly in China and Singapore. However, Europe really stands out with its detailed requirements and regulations, thereby stepping away from a voluntary mode that has been pervasive for so long.

For the financial sector, this agenda offers many strategic opportunities to adopt a leading and distinctive role ahead of non-European peers and to improve the sustainability product suite. With a greater portion of investments directed to sustainability, financial intermediaries that offer truly sustainable finance solutions are well-positioned. A mechanism that the EU Taxonomy is likely to trigger in the debt markets is the increase in the credit spread of brown companies versus their green peers. The EU would like to leverage its finance sector as a force for good that can provide capital to green and sustainable business and help fuel inclusive economic growth.

2. Building on existing guidelines and commitments

While the considerable range of regulations and proposals may be daunting at first, they clearly link to and build on existing international guidelines and principles. Take for example the OECD Guidelines for Multinational Enterprises, the UN Global Compact, and the UN Guiding Principles on Business and Human Rights - including the International Labour Organisation's (ILO) declaration on Fundamental Rights and Principles at Work, the eight ILO core conventions, and the International Bill of Human Rights. Generally speaking, these guidelines have already been implemented into the codes of ethics and business conduct of many companies. Furthermore, the EU regulations and proposals have built upon the Greenhouse Gas Protocol, the Paris Climate Agreement, the UN Sustainable Development Goals as well as the work undertaken by the Task Force on Climate-related Financial Disclosures (TCFD).

3. More transparency for the end investor is helpful

Putting the interests of the end investor first, the European regulations and proposals aim to enforce more focused and better structured transparency. This applies both to financial market participants and financial advisors in their communication to their clients, whilst introducing new concepts such as 'principal adverse sustainability impacts'. By way of example, the EU Disclosure Regulation describes in considerable detail what financial intermediaries should include in their policies on sustainability risk, adverse sustainability impacts, integration of sustainability risks, and includes higher hurdles for financial products that promote environmental or social characteristics, and sustainable investments. There is the risk of overshooting with some of the disclosure being very comprehensive, such as the proposed adverse impacts statement that is part of the Regulatory Technical Standards. Ultimately, the proof of the pudding is in the eating, on whether this level of transparency and the related workload behind it will indeed aid the end investor in their decision-making, particularly as no distinction is made between professional and retail investors. If, when the regulations are introduced, they then overshoot, we run the risk of the end investor not being able to see the forest for the trees with the potential result of greater confusion and box ticking exercises.

4. ESG data availability and quality need to improve

Investors need high quality environmental, social and governance (ESG) data in order to better map the risks and opportunities of their investments. This continues to be a struggle with material information not being disclosed, or with inconsistent definitions, very backward-looking, with no link to the corporate objectives and risk management and governance framework, and insufficient or no independent assurance. Still, investors like ourselves and our clients need trustworthy and robust sustainability information. This affects the entire investment value chain, ranging from the portfolio strategy to voting and engagement and client reporting.
ESMA (the European Securities and Markets Authority) and other European institutional authorities have been tasked with drafting the Regulatory Technical Standards (RTS) that apply to the EU Taxonomy Regulation and EU Disclosure Regulation. In their 'Joint Consultation Paper ESG Disclosures'[7], 50 detailed 'adverse sustainability indicators' are introduced to be reported against at both the listed company level and investment/fund level. These data fields cover two broad areas: environmental (climate and other environment-related indicators) and social (social and employee, respect for human rights, anti-corruption and anti-bribery matters) and are divided into 32 principal and 18 additional indicators.

Figure 2: Adverse sustainability indicators by topic

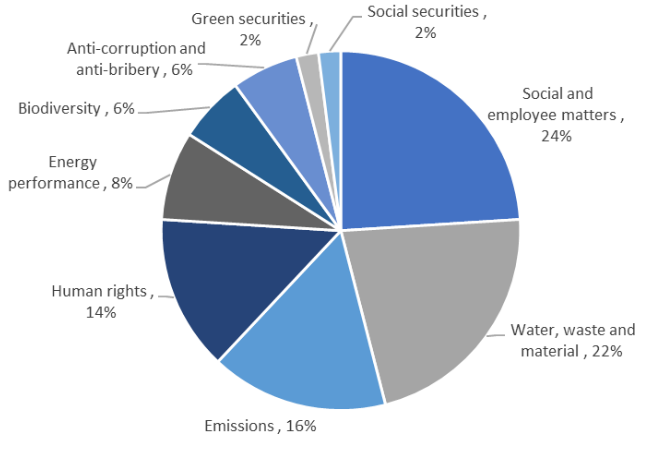
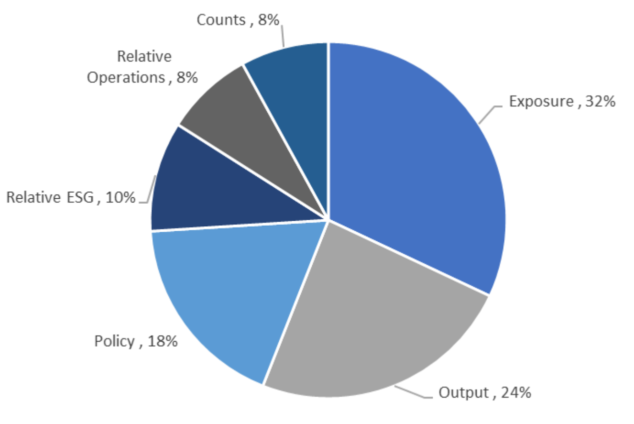


Figure 3: Adverse sustainability indicators by data type



Source: Van Lanschot Kempen analysis

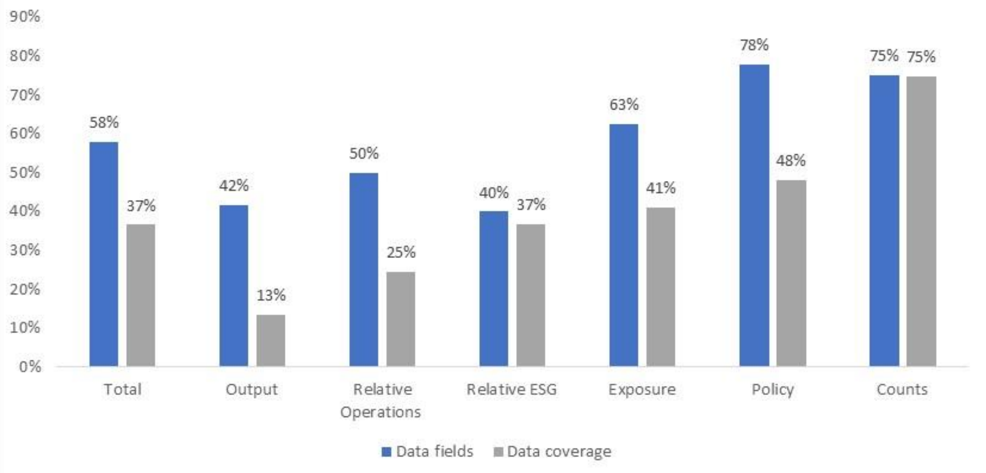
Data type	Explanation
Exposure	Share in investments/ activities with higher sustainability risk
Output	Standalone ESG data point
Policy	Reference to ESG policy
Relative ESG	ESG performance linked to ESG metric
Relative Operations	ESG performance linked to business operations metric (e.g. revenues)
Counts	Number of issues/ cases/ incidents

[7] Joint Consultation Paper ESG Disclosures - Draft Regulatory Technical Standards Regulation (EU) 2019/2088, April 2020

Arranging all the data fields by topic, we conclude that the two most important themes (by number of indicators) are 1) social and employee matters, and 2) water, waste and material (figure 2). Looking at the type of data, many fields refer to exposure of investments, to policies (or rather the absence thereof) or simple counts (number of controversies or instances). According to our data classification, 21 of the 50 indicators represent meaningfully quantifiable ESG data that are subject to a calculation methodology and more closely related to financial data (see figure 3) rather than corporations' activities and behaviours. It is not clear to us how the indicators connect to the adverse sustainability impacts in terms of the significance and likelihood of occurrence and the explanation around principal and additional.[8]

In order to better assess the relative data availability, we analysed the EU universe of the MSCI Europe IMI index (Investable Market Index), comprising some 872 large, mid and small cap companies across the developed markets in the EU countries (62% of the index). From our analysis, it follows that there is a gap in terms of the data fields capturing the 50 indicators in full or in part, particularly at the end of the ESG rating providers – more so than the financial/ESG data providers. Aside from mapping the RTS indicators to identified ESG data fields, actual data coverage is essential to be able to provide the desired transparency. *Overall, we conclude that for over 60% of the environmental and social indicators there is not yet any available data coverage* – based on our mapping of the ESG data fields from the ESG rating provider. It also follows that many of the ESG 'data' points have a tilt to counts (number of issues/cases/incidents), policies and exposure. This underlines ESG rating providers' historical positioning and confirms a larger data coverage gap for output, relative operations and relative ESG fields (see figure 4). A mere count of policies/ incidents is also a weaker proxy of the quality of relevant ESG issue management at the company level. Also, while financial intermediaries may turn to corporate ESG reports for screening and engagement purposes, it is in most cases out of scope to collect raw data on all portfolio companies to comply with a broad range of reporting requirements.

Figure 4: ESG data fields and data coverage



Source: Van Lanschot Kempen analysis

At the end of the day, the information that the RTS are proposing comes from the sustainability reporting of investee companies. Our analysis points to a substantial disclosure challenge with many ESG data fields not being sufficiently disclosed by developed market EU companies. Worryingly, it does not stop here with asset managers also required to disclose information around the adverse sustainability indicators for non-European issuers. This begs the question of how we proceed, with corporate ESG disclosure in general not yet meeting the required standards. The RTS suggests applying 'best efforts' if information is not available from investee companies.[9] It remains to be seen however, how estimates - for example provided by ESG rating providers - might be an acceptable (interim) solution or worse, leave room for continued greenwashing.

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[8] The Global Risk Report of the World Economic Forum has undertaken this exercise for many years. See: http://www3.weforum.org/docs/WEF_Global_Risk_Report_2020.pdf

[9] Joint Consultation Paper ESG Disclosures - Draft Regulatory Technical Standards Regulation (EU) 2019/2088, April 2020, article 7.2b and article 34j.

5. A central ESG data repository would be helpful

An important question is where the ESG data is to come from and how it will be disseminated. The business model of ESG rating providers is to provide ESG scores and ratings that enable investors to compare the ESG performance of individual securities. Part of the input is based on raw ESG data as disclosed by issuers, but other elements are important as well such as the weight of a topic, the availability of data points, policies, controversies, relative performance and many more. There has been a fair amount of criticism of ESG rating providers, specifically about their lack of deeper transparency behind the scoring methodologies. This prompted the Chair of ESMA back in February to call for ESG rating providers to be regulated and supervised by public sector authorities.[10]

Against this backdrop, it comes as no surprise that there have been a number of calls for setting up a centralised European electronic register for ESG data. There was a similar plea in November 2018, around the timing of the 'fitness check' of the EU framework for corporate reporting,[11] This was echoed in June this year by six European associations representing the financial sector including the European Fund and Asset Management Association (EFAMA) in their letter to the European Commission. They referred to the urgent need for publicly available and comparable ESG data as well as better sourcing on the back of the EU Sustainable Finance agenda. 'With an increasing demand for ESG information, the fragmentation in ESG third-party data providers risks to lead to insufficient availability of comparable and reliable ESG data as well as to unnecessary costs and competition concerns.'[12] To elaborate on the cost argument, spending in Europe on ESG content is estimated to be nearly €280m this year.[13] All in all, the move to a European ESG data repository would be helpful and would begin to tackle the issue of fragmentation of ESG data as well as facilitate alternative intelligence-based data retrieval strategies. Ensuring that corporate ESG reports apply a standardised reporting methodology (calculation of disclosures, including the setting of boundaries per disclosure item) would be an important consideration for ensuring the usefulness of the repository, we would argue.

6. Greater standardisation of sustainability reporting is needed

As there still is no single standard for sustainability reporting that has the backing of all key stakeholders (including regulators), companies are using different standards such as GRI (Global Reporting Initiative), SASB (Sustainability Accounting Standards Board), systems such as CDP (formerly known as Carbon Disclosure Project), or frameworks, like Integrated Reporting (IIRC: International Integrated Reporting Council), and others. From a user perspective, this poses a real challenge as many data points and definitions are not comparable – they were not designed to apply the same logic and expected use case. In the European regulations, the consultation paper containing the RTS also leaves it open about which framework or concept the metrics should be reported against.

We see it as a missed opportunity that the RTS committee did not tap into three existing initiatives. First, the World Federation of Exchanges came with an update of its ESG Guidance & Metrics in June 2018. This had first been developed in 2015 and is a reference guide for stock exchanges in setting ESG reporting guidance for their listed companies. The initiative introduced 30 disclosures (equally divided along the environmental, social and governance pillars) and maps these to TCFD, SASB and GRI.[14] Among others Nasdaq (globally) has adopted this approach.[15]

Second, there are calls for the International Accounting Standards Board to establish an ESG Reporting Standard[16], in an initial phase looking at the most financially material, quantifiable climate risks to support economic decisions of market participants[17]. This approach is termed 'broader financial reporting', to help users of financial statements see how companies are balancing the focus between long-term strategies and short-term earnings. This approach would not cover the full scope of disclosures the EU regulations are calling for, but it would address most of the concerns regarding the authoritative nature of the standard setter.

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[10] 'ESG rating agencies should be regulated: ESMA chief weighs in on data debate', Responsible Investor, 13 February 2020
[11] 'Norges Bank calls for central data repository for sustainability disclosure', Responsible Investor, 30 November 2018
[12] See: https://www.ebf.eu/wp-content/uploads/2020/06/Joint-industry-letter-ESG-EU-data-register_EACB_EBF_EFAMA_ESBG_IE_PE.pdf
[13] Opimas
[14] See https://www.world-exchanges.org/news/articles/world-federation-exchanges-publishes-revised-esg-guidance-metrics
[15] See https://www.nasdaq.com/ESG-Guide
[16] See for example the Eumedion Green Paper on the future of non-financial reporting
[17] See: https://www.ifrs.org/news-and-events/2019/04/speech-iasb-chair-on-sustainability-reporting/

Third, the World Economic Forum's International Business Council (IBC), together with the Big Four accounting firms, is proposing a set of common metrics and reporting disclosures around ESG factors.[18] Their aim is to bring the most material sustainability aspects into mainstream financial reports on a consistent basis. Four pillars have been defined (governance, planet, people and prosperity) and 22 metrics have been drawn from existing standards and disclosures.[19] Aside from the 22 core metrics - the minimum requirement - there are 30 additional metrics. It is the expectation of the IBC that many companies will report against these metrics from their annual reports from 2020 onwards.

7. No requirements with regard to independent verification or audit processes

Ultimately with the EU Disclosure Regulation and EU Taxonomy Regulation, users rely on the information being reliable and provided with assurance. Nonetheless, this reliability aspect and the requirements around verification and audit processes (e.g. limited reasonable assurance) are not (yet?) defined in the regulation. Even the NFRD has not required any assurance of the content of the 'non-financial statement'. Nonetheless, it gives room for member states to 'require that the information in the 'non-financial statement' be verified by an independent assurance services provider'.[20] In the consultation of the NFRD, eight of the 45 questions (or 18%) are about assurance and whether EU law should impose stronger assurance requirements for the sustainability information reported. We would be supportive of the EU strengthening its requirements for assurance of sustainability information by law as part of the NFRD. Sustainability information is important information not only for stakeholders, but increasingly for the corporation itself, we would argue. It delivers the full picture of a firm's value creation, and can also serve as a leading indicator of financial performance. This warrants sustainability KPIs to be part of an integrated dashboard and be firmly embedded in the management control cycle. Given this strategic significance, both external and internal parties need robust and trustworthy information that is externally assured. Furthermore, we argue that the assurance provider should assess the reporting company's materiality assessment process and key engagement risks. Ideally, this would all be based on a common assurance standard. In the Netherlands, auditors must verify whether the 'non-financial statement' has been prepared in accordance with the Disclosure of Non-Financial Information Decree and the Diversity Decree and is consistent with the annual report, and whether the 'non-financial' statement contains any material misstatements considering the knowledge and understanding of the undertaking and its environment obtained during the performance of the audit procedures.[21] The refinement and scaling of sustainability assurance standards, such as the ISAE 3000, might be a worthwhile opportunity to consider.

Conclusion

The long-term sustainability agenda of the EU represents many opportunities for both the financial sector as well as end investors. Undeniably, the workload may be substantial as the regulation affects many core elements ranging from product design, to client documentation and reporting, IT infrastructure and ESG data provider relationships. An additional layer applies to publicly-listed asset managers that are required to meet stricter ESG disclosure requirements at the holdings level as well. Suffice to say that the regulation is complex and greater convergence and harmonisation of existing regulations is recommended. In our analysis, we have pointed to a gap in terms of ESG data points on the back of the RTS. Availability of more and better ESG data is key for both asset managers and their clients in seeking greater exposure to sustainable investments. At Van Lanschot Kempen and Kempen Capital Management, we take an active role in contributing to a wide range of consultations on EU regulations in order to share our views and suggest areas of improvement.

In summary, the European regulations offer us many opportunities that play to our strengths as a dedicated sustainable wealth management specialist. We are convinced that the wealth we build or preserve now for our clients will only retain its real value in a sustainable world. We have been using our

[18] See World Economic Forum, Toward Common Metrics and Consistent Reporting of Sustainable Value Creation, Consultation Draft, January 2020 (http://www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf)
[19] Think of the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), Taskforce on Climate-related Disclosures (TCFD), Climate Disclosure Standards Board (CDSB) and others.
[20] EU Directive 2014/95/EU
[21] Besluit bekendmaking niet-financiële informatie', 14 March 2017

leverage as an active owner to create value for all stakeholders in the long term and will continue to do so in the context of - among others - working towards the climate neutrality of all of our investments.

About us

Kempen Capital Management N.V. (hereafter Kempen) is a specialist asset manager focused on niche investment strategies. Since 1991, we have been committed to assisting our institutional and wholesale clients and now help them invest in small-cap and high-dividend equities, real estate, credits and alternatives. We also offer dedicated tailored solutions to large and small clients, insurance companies, trustees and family offices, encompassing asset allocation, portfolio construction and analytics, and manager selection and monitoring. We manage a total of €76.2 billion in assets (as of end December 2019), of which €17.6bn is in Investment Strategies and €58.6bn in Solutions. Kempen has been a signatory of the Principles for Responsible Investment since 2008 and was awarded an average score of 'A' on its responsible investment process and an 'A+' on strategy & governance, equity and fixed income in 2019.

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