EU Newsletter Sustainability Reporting

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Much has happened over the summer in the sustainability reporting landscape.

From a standard perspective, the European Commission (EC) has adopted the European Sustainability Reporting Standards (ESRS) to align sustainability reporting with financial reporting. The ESRS consist of two cross-cutting standards and 10 topical standards covering environmental, social and governance (ESG) aspects. They will be applicable from 1 January 2024 for the first filers.

Large companies covered by the Corporate Sustainability Reporting Directive (CSRD) must comply with the ESRS when preparing their sustainability reports for the 2024 financial year. Two CSRD project managers share with us their experience of implementing ESRS in their companies, including performing a materiality and gap analysis, anticipating regulations, involving the finance department, quantifying risks, and educating stakeholders about the double materiality approach.

In our newsletter, you will also find a comprehensive analysis comparing the sustainability disclosure proposals from the European Union (EU), International Sustainability Standards Board (ISSB), and Securities and Exchange Commission (SEC). We explore their applicability to companies and provide guidance on developing an effective reporting strategy.

In other regulatory news, the EC published the Environmental Delegated Act, which defines the technical screening criteria of the four other environmental objectives. The Act also includes changes to the Disclosures Delegated Act and the Climate Delegated Act. These changes cover various environmental objectives and modifications to activities.

The EU green bond standard (EU GBS) is a benchmark for green bonds, and it aims to bridge the gap between sustainable investment demand and financing. It mandates independent external review of pre-issuance green bond fact sheets and final allocation reports. Alignment with the EU Taxonomy is required, with a flexibility pocket of 20%. The European Parliament has proposed an impact assessment on making the EU GBS mandatory for bonds marketed as 'environmentally sustainable' or 'green'.

The EC has also proposed a Regulation to enhance the reliability of ESG ratings, setting transparency requirements for ESG rating providers operating in the EU. The Regulation includes measures such as an approval procedure, rules on independence and conflict of interest management, and a solid governance system.

Our newsletter explores these topics in more detail.

Enjoy your reading.

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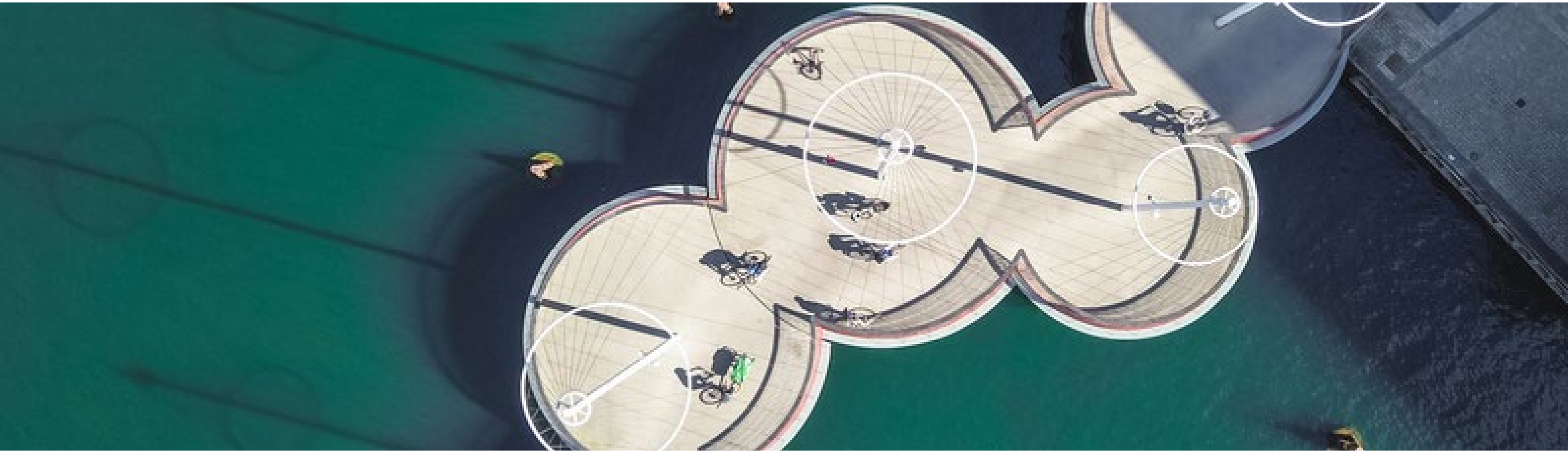
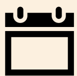
Sustainability Reporting Standards



Final European Sustainability Reporting Standards have been adopted



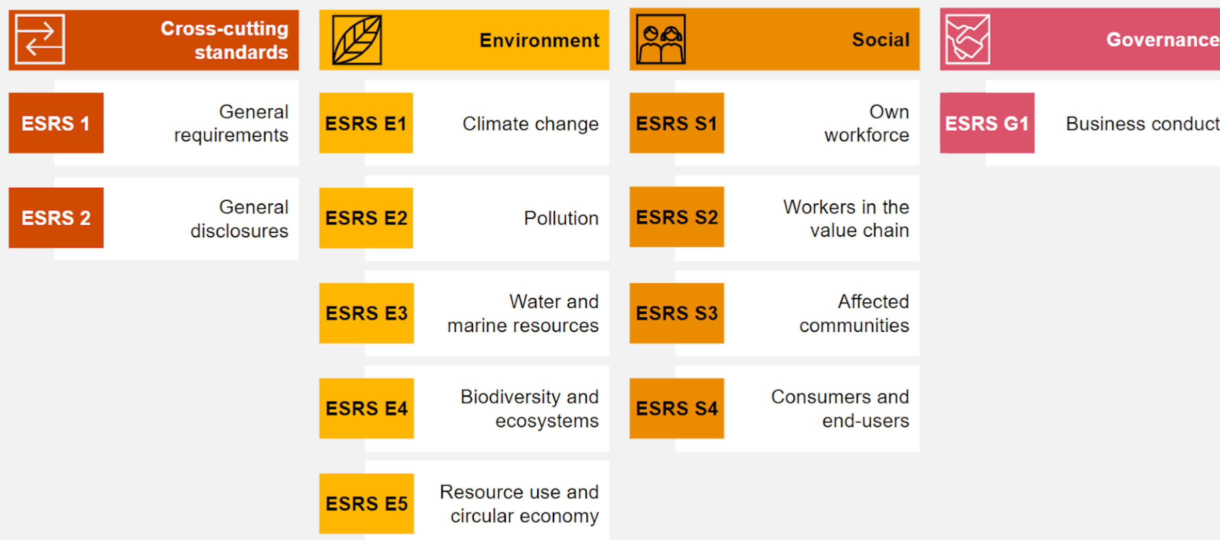
On 31 July 2023, the European Commission (EC) adopted the final delegated act of the European Sustainability Reporting Standards (ESRS). After a two-month scrutiny period ending on 21 October 2023, the delegated act was also approved by the European Parliament and the Council of the European Union.

The delegated act includes the 12 finalised ESRS, made up of two cross-cutting standards, which apply to all sustainability matters, and 10 topical standards covering a wide range of environmental, social and governance (ESG) matters.

What is the issue?

The ESRS are the sustainability reporting standards that underpin the Corporate Sustainability Reporting Directive (CSRD). The aim of the CSRD, which has been in force since January 2023, is to bring sustainability reporting on a par with financial reporting. To achieve this objective, companies must provide relevant, comparable and reliable information on their sustainability-related impacts, risks and opportunities. The ESRS include detailed and standardised disclosure requirements for companies to report on ESG matters.

The delegated act, including its appendices, is available in all EU Member States' languages. As noted above, the ESRS include two cross-cutting standards that define the general reporting principles and the CSRD fundamental concepts (including double materiality and reporting boundaries), as well as the overarching disclosures that are to be made by all companies within the scope of the CSRD. The 10 topical standards include the specific reporting requirements for ESG matters:



The final ESRS reflect updates to the 12 previous draft ESRS that were issued by the EC for public feedback on 9 June 2023. Responses were due by 7 July 2023. The EC received over 600 comments, including feedback from PwC.

What are the main changes compared to the June 2023 version issued by the EC for public feedback?

The EC included an overview of significant changes compared to the draft ESRS which were handed over to the EC by the European Financial Reporting Advisory Group (EFRAG) in November 2022. Based on our preliminary assessment, the changes made after the feedback period in June 2023 include the following:

- The terminology around financial materiality to align further with the definition of financial materiality in the IFRS® sustainability disclosure standards.
- A provision within the materiality section which requires a detailed explanation when a reporting entity concludes that climate change is not a material topic.
- An additional provision to facilitate the compliance of financial market participants, benchmark administrators and financial institutions with their own disclosure obligations from other EU law: if the reporting entity concludes that a data point derived from such EU law is not material, it should explicitly state that the data point in question is "*not material*".
- A requirement to disclose a table with all data points derived from other EU law, indicating where they are to be found in its sustainability statement or stating "*not material*", as appropriate.

International interoperability

The EC has stressed the importance of the alignment of the ESRS with global standards such as the IFRS sustainability disclosure standards and the Global Reporting Initiative (GRI). In its press release about the adoption of the ESRS, the International Sustainability Standards Board (ISSB) confirmed the high degree of alignment between its and the ESRS climate disclosures. Furthermore, interoperability guidance material from the EC, EFRAG and ISSB, which is due out shortly, should assist entities in navigating between the standards and in understanding where there are incremental or different disclosures required by one or the other set of standards.

In this respect, EFRAG has recently made available papers on the interoperability of ESRS with the GRI standards and the IFRS sustainability disclosure standards.

Phasing-in and voluntary disclosures

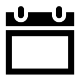
Additional phase-in reliefs and voluntary disclosures introduced in the June 2023 draft ESRS remain substantially unchanged. These are summarised below, and they are described in more detail in our In brief 2023-13. The additional reliefs are intended to reduce the reporting burden for companies and to facilitate the first-time application of the standards.

Standard	Disclosure requirement	For all companies	For companies and groups with ≤ 750 employees	
			Year 1	Year 2
ESRS E1-E5	Anticipated financial effects	Year 1: may be omitted Year 1-3: qualitative information only*		
ESRS E1	Data points on scope 3 and total GHG emissions		May be omitted	
ESRS E4	All disclosure requirements		May be omitted**	May be omitted**
ESRS S1	Selected disclosure requirements and data points	Year 1: may be omitted		
ESRS S1	All disclosure requirements		May be omitted**	
ESRS S2-S4	All disclosure requirements		May be omitted**	May be omitted**

* With limited exceptions and for E1 only if it is impracticable to prepare quantitative disclosures.
** The sustainability matters covered by the ESRS are still to be included in the materiality assessment. A brief description of any time-bound targets, policies, and actions as well as the disclosure of relevant metrics is still required.

Examples of voluntary disclosures include the transition plan for biodiversity and ecosystems (ESRS E4) and information on non-employee workers in ESRS S1 (for example, with respect to adequate wages, social protection, and health and safety). An explanation of why certain sustainability topics have been classified as not material is also a voluntary disclosure (with the exception of the climate change topic).

The European Commission work programme for 2024: deferral of sectoral ESRS by two years



On 17 October 2023, the Commission published its work programme for 2024. The work programme includes among other initiatives a proposal to postpone the deadline for the adoption of the sectoral European sustainability reporting standards currently planned for June 2024 by two years. The work programme can be found here.

EFRAG guidance on materiality assessment, value chain information and ESRS data points

Guidance on materiality assessment, value chain, and ESRS data points

In March 2023, Commissioner McGuinness publicly called on EFRAG to prioritise implementation guidance on the first set of ESRS over the preparatory work for the draft sector-specific standards. In late July 2023, EFRAG published its long-awaited draft 'Implementation guidance for the materiality assessment' (MAIG) and draft 'Implementation guidance for value chain' (VCIG). Both sets of implementation guidance seek to provide non-binding technical guidance on the application of ESRS and to address frequently asked questions. These questions include how to perform the double materiality assessment, how to assess risks and opportunities, the level of disaggregation across impacts, where the value chain begins and ends, what is a reasonable effort to collect value chain data, and so forth.

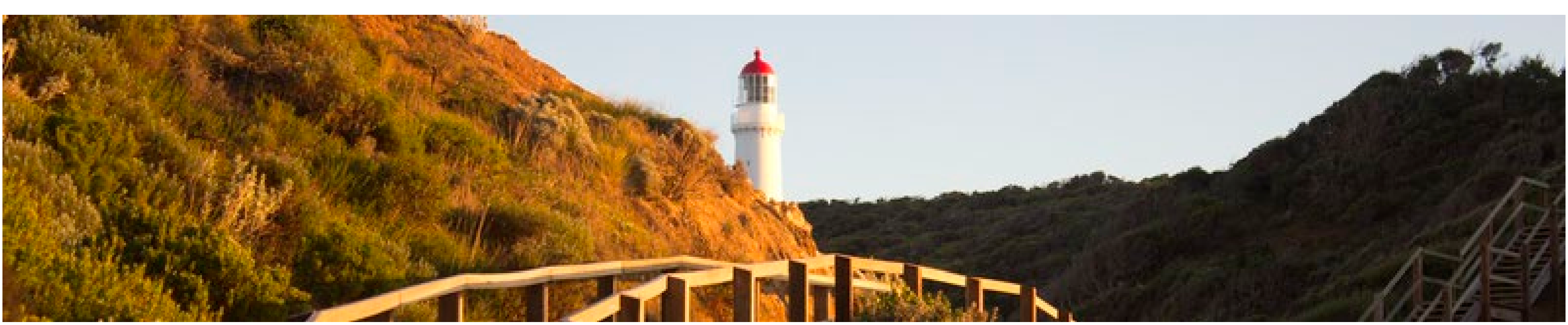
It is expected that EFRAG will publish its draft guidance for public consultation in November, with a one-month comment period.

In another effort to provide non-authoritative implementation guidance and other material to support the application of the sector-agnostic ESRS, EFRAG released a '[Draft] list of ESRS data points – Implementation Guidance" early November for approval by the EFRAG SRB. The Excel workbook presents the complete list of disclosure requirements in the sector-agnostic standards, and it covers all of the standards except ESRS 1, 'General Requirements', which does not set specific disclosures.

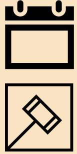
EFRAG work programme 2024

In October 2023, EFRAG released the work programme for 2024. Beside including the implementation guidance activities already referred to, the work programme includes the following activities:

- ESRS implementation support: EFRAG will launch an ESRS implementation Q&A process through a centralised access point. The Q&As will be published by EFRAG on a quarterly basis.
- ESRS for listed SMEs (LSME): EFRAG will issue an ESRS LSME exposure draft for public consultation in January 2024 and its technical advice ESRS LSME to the EC in November 2024.
- Voluntary reporting standard for non-listed SME (VSME): EFRAG will issue an exposure draft of the VSME in the first quarter of 2024 for public consultation and its technical advice ESRS VSME to the EC by November 2024.
- ESRS XBRL Taxonomy: EFRAG will issue the XBRL taxonomy in the first quarter of 2024 and, in the second half of 2024, it will issue its final advice.
- Sectoral ESRS: EFRAG expects to finalise the exposure drafts of (i) the general approach to sectoral ESRS, (ii) the ESRS Sector classification approach, based on the statistical classification of economic activities in the European Community (NACE), and (iii) two draft ESRS for high-impact sectors, respectively oil and gas (covering activities from upstream to downstream), and mining, quarrying and coal. The timing for public consultation(s) in relation to those exposure drafts will be considered in due course.
- ESRS for non EU-groups: EFRAG will issue exposure drafts for consultation in the fourth quarter of 2024 or the first quarter of 2025 at the latest.



CSRD: feedback from two large French groups on implementation of the ESRS



As of 2025, large companies covered by the CSRD will have to comply with the ESRS defined by Europe when drawing up their sustainability reports (for the 2024 financial year). Two CSRD project managers share their experience of implementing ESRS in their companies.

The Corporate Sustainability Reporting Directive (CSRD) was published in the OJEU on 16 December 2022. The French government must transpose it into French law by the end of 2023. It provides for the mandatory use of reporting standards, 'European Sustainability Reporting Standards' (ESRS), to create a common language and enable comparisons between sustainability information published by companies. A first set of draft standards, covering the reporting obligations of large companies, was sent by EFRAG to the European Commission in November 2022. They were finally adopted by delegated act on 31 July 2023.

Two CSRD project managers from two large French groups, specialising in the automotive (interviewee 1) and cosmetics (interviewee 2) industries, answered our questions on the implementation of ESRS within their companies, and shared with us their advice and recommendations (action plan, double materiality assessment, transformation challenges, etc).

How did you react to the draft ESRS published by EFRAG?

Interviewee 1:

It's not unusual to feel discouraged by the growing number of regulations to come. The texts are indeed very complex, with a multi-layered approach:

- the CSRD ;
- agnostic standards, which apply to all companies, whatever their sector of activity;
- specific standards, which will apply to different sectors, meaning that, for groups with multiple activities, several standards will have to be applied;
- and, finally, entity-specific disclosures.

This step-by-step approach will increase the burden and weight of the information to be provided over time.

To avoid panicking in the face of this mountain of texts, we need to think about the context that gave rise to these new regulations. The aim of these regulations is to make companies' CSR communications comparable. Stakeholders are confronted with a huge diversity of CSR messages, with different formats and KPIs, sometimes identical indicator labels, but completely different calculation methods.

As for companies, they have to fill out numerous questionnaires throughout the year at the request of investors, banks, generalist rating agencies, specialist rating agencies, NGOs, universities, etc. So, both for stakeholders and for companies, this standardisation of approach and communication of CSR reporting is positive, and something to hold on to.

What are your recommendations in terms of action for plans implementing ESRS?

Interviewee 1:

The 1st step is to take the time to understand the texts and share a common interpretation internally, because the texts are far from obvious.

The 2nd step is to identify the people in the company who will be responsible for implementing this new reporting system. We'll need to broaden the scope of the people who were previously involved in sustainability reports, and involve all the functions concerned by this new approach to sustainability. It will also be necessary to train them in ESRS, so that everyone understands the scope

of the change in mindset. In effect, this is a new approach to sustainability, since we start from risks and opportunities. We're going to be asking questions about the company's business model, its governance, its processes and the policies it has or hasn't put in place. It will therefore be necessary to involve skills that are not necessarily all coordinated around the issue of sustainability reporting, such as risk management, management control, operational functions and corporate strategy.

The 3rd step is 'gap analysis', which consists of measuring the gap between the regulatory expectations and the company's reality – that is, identifying the information already published by the company, that which it is possible to obtain easily, and all the information that is missing.
Finally, the last stage involves resolving the gap between the company's reality and what is expected by the ESRS.

In our company, we have begun work on a materiality assessment, which I believe is the cornerstone of the system. Indeed, it is on the basis of this materiality assessment that we will be able to engage the right levels of involvement of operational functions in ESRS-based reporting. Implementing these new regulations will involve a real effort on the part of companies, even those already subject to reporting, so my recommendation is to anticipate.

Interviewee 2:

The exercise we're asked to carry out undeniably requires anticipation.

When we take a step back in ESG reporting, we can see that we've moved from an exhaustive approach with the pre-existing law (Grenelle law) to a materiality approach based on risk management. In the future, with the CSRD and ESRS, companies will be asked to revisit the materiality of ESG issues by integrating impacts and opportunities, with the dual focus of impact materiality and financial materiality. Once the subject has been considered material, companies will be asked to return to an exhaustive approach, adopting numerous standardised KPIs. This represents a considerable amount of work, especially for companies producing their first ESG reports. It is therefore advisable to start as soon as possible and, ideally, to use the 2023 financial year (and therefore the 2024 reporting) to test the new KPIs to be implemented.

Undeniably, the action plan starts with the double materiality matrix that we produced last year on the basis of the draft ESRS submitted for public consultation by EFRAG in April 2022.

On the 'gap analysis', we decoupled the quantitative part from the qualitative part to make the work more digestible. Faced with the increase in the number of KPIs to be produced, and with a new level of granularity, we took advantage of the opportunity to try to simplify the work of the teams by refocusing on the essentials, while also seeking to optimise processes and to pool resources to achieve an integrated vision. On this basis, we have identified three categories of KPIs:

- KPIs that already correspond to those set out in the draft standards prepared by EFRAG;
- KPIs to be created to comply with the texts; these are essentially forward-looking KPIs with a financial angle; and
- KPIs historically monitored by the company, but which do not correspond exactly to what is required by the ESRS projects.

We quickly identified 'quick wins', such as a ratio of greenhouse gas emissions to sales. Other KPIs, on the other hand, require more thought. This is the case for KPIs based on different units, or for certain subjects on which we have historically focused but for which the standards projects require less granularity.

Have you identified any areas of concern regarding the implementation of ESRS?

Interviewee 1:

I've identified two warning signs. My first point concerns the need to work more closely with the finance departments as soon as possible, because some of the indicators required by the draft ESRS are financial elements, but are not available from the finance departments. For example, it's far from easy to quantify risks and opportunities in Euros. It will therefore be necessary to anticipate the various needs of the finance departments.

My second point of warning concerns the 'Own workforce' part of the Social pillar of ESRS. For example, when it comes to accidents in the workplace, national regulations apply and, in France, our regulations include many more accidents in the definition of 'accidents in the workplace' than in other countries. This means that France is at greater risk of appearing as the country with the highest number of workplace accidents. This is a warning point that has been brought to the attention of EFRAG and the European Commission.

You told us that you had already implemented a materiality assessment. What are your points of attention concerning the principle of double materiality?

Interviewee 1:

As you know, there are two aspects to consider. Firstly, there's financial materiality, that is the effects of sustainability factors on the company. Despite the existence of rules defining this, there is considerable room for interpretation: how is this economic materiality defined? How do we combine it with the risk assessments carried out within the company? It's not easy to define a methodology, and there's a real lack of guidance, especially for new companies about to join the scheme.

Then there's impact materiality, which consists of looking at how the company's activities have an impact on society and the environment. What is particularly new in impact materiality is the strengthening of the role of stakeholders in the system. The principle of double materiality requires issues with a strong impact or significant economic materiality to be considered. It is possible to imagine an issue with low economic materiality but high impact materiality. The issue will then be considered as material, and this is where the role of stakeholders becomes decisive.

Another point to bear in mind is that it is from this materiality matrix that the extent of reporting will derive, since, apart from the mandatory application of certain ESRS, all other ESRS will be subject to the materiality assessment carried out by the company. The role of stakeholders will therefore play a decisive role in the volume of our reporting and the amount of effort required.

A final point of warning will concern major groups in particular: the fact of deeming a subject to be non-material risks being a trap, because stakeholders will undoubtedly still expect to have information on certain subjects, even if these subjects have been considered non-material and set aside by companies.

In addition to these warning points, I have identified four major difficulties concerning the principle of double materiality:

- The first difficulty is to educate stakeholders about the dual materiality approach. It's not easy to explain the notion of materiality impact to them, to ensure that the questions they are asked are understandable, and to convince them to give us a little of their time for a complex questionnaire. I recommend that companies call on a neutral third party to conduct these materiality analyses, to ensure that all their stakeholders are treated fairly.
- The second difficulty is to refine our calculations of economic materiality by estimating in Euros the risks and opportunities for each CSR issue.
- The third difficulty is the amount of time we have to devote to the task, since the work involved is substantial. There are major organisational impacts, and we need to be able to mobilise resources that will have the time to deal with the new regulations. Internal control has to be involved, tools have to be developed to capture data in a more ergonomic way and, above all, reporting has to be carried out in a much shorter time than before.
- The final difficulty is that of being alone in the face of regulatory texts: how can we be sure of the correct interpretation of double materiality?

What do you see as the prospects and challenges for the transformation of the ESRS?

Interviewee 2:

Reporting must remain at the service of strategy and serve to steer performance. We must therefore avoid the predictable pitfall of a purely ‘compliance’ exercise, which would empty the teams' work of its content and distract them from the real challenge, which is to work towards transformation. With the CSRD and ESRS, we have changed the paradigm. In contrast to the current sustainability report, reporting is no longer simply a matter of reporting performance based on sound risk management; we now need to be able to project our business model over the short, medium and long term, anticipating the risks weighing on our business, but also taking into account the impacts generated by our business, and ultimately valuing the opportunities that could emerge from it. And, since it is not possible to publish impacts without presenting moderation or mitigation objectives, reporting undeniably encourages action.

Furthermore, to avoid ‘greenwashing’, action plans and the resources allocated to achieve the objectives defined by the company must be published, which implies being ambitious, but at the same time pragmatic and transparent. The regulator is therefore accelerating the potential of reporting as a self-regulatory tool that encourages reflection in a given direction, and de facto encourages the company to take action.

Many say that we're getting closer to the requirements of financial reporting, and rightly so in many respects, but this forward-looking part where the regulator and standard-setter encourage companies to set targets, publish action plans and allocate resources is quite unique. It is therefore important that these forward-looking data are based on reliable processes that are argued and shared with experts, both internal and external, statutory auditors, independent third parties and other stakeholders. It is also essential to promote acclimatisation to these new requirements at all levels, particularly with regard to the audit committee, which will be responsible for monitoring the integrity of the process for drawing up sustainability information, in the same way as for financial statements.

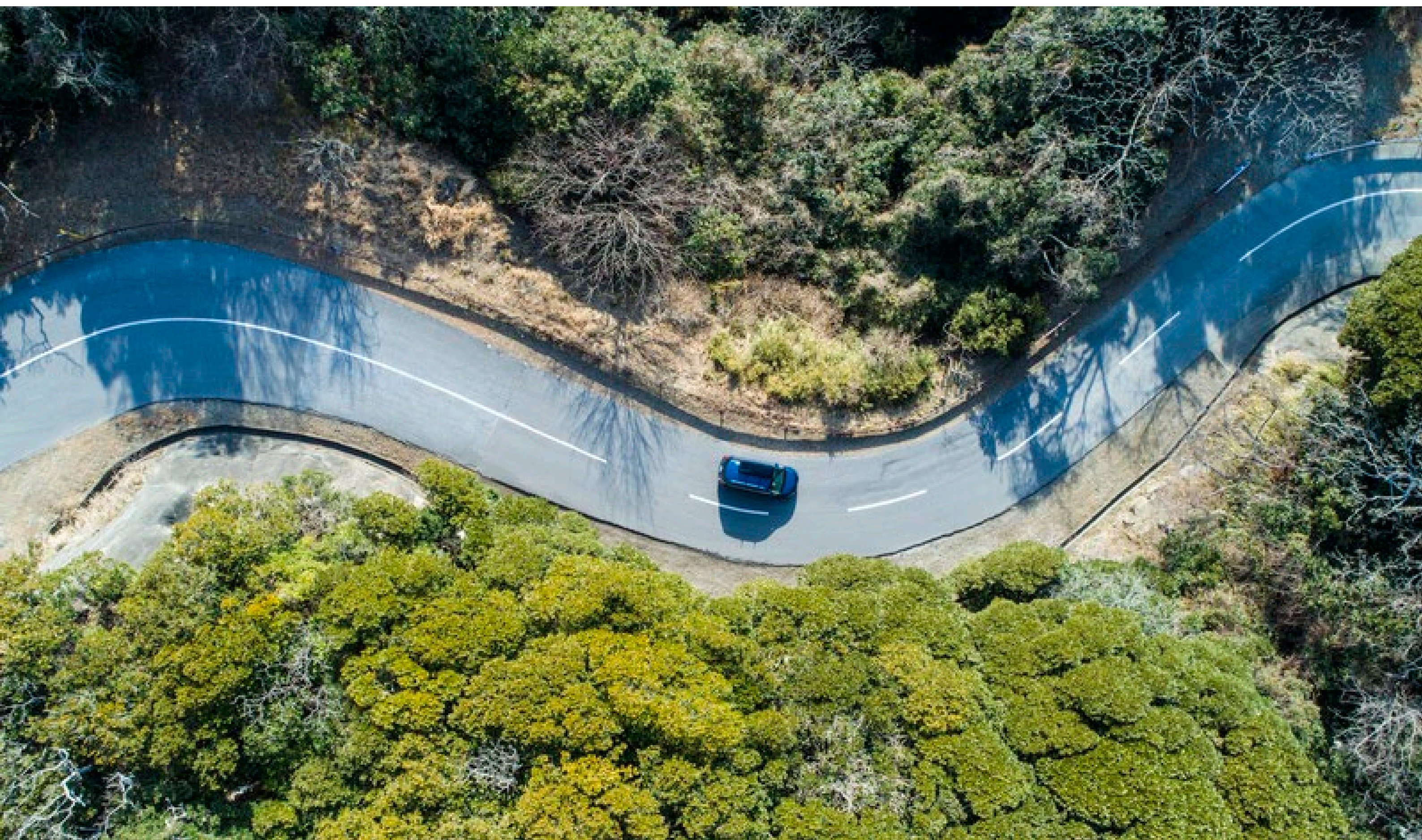
Navigating the ESG landscape: comparison of the 'big three' disclosure proposals

After years of increasingly vocal demand for enhanced transparency about ESG matters from investors and other stakeholders, regulators and standard setters in various jurisdictions issued definitive proposals to transform ESG reporting in 2022. The year brought proposed ESG disclosures from the European Union (EU) as part of the Corporate Sustainability Reporting Directive (CSRD), internationally by the International Sustainability Standards Board (ISSB), and in the United States (US) by the Securities and Exchange Commission (SEC). These 'big three' disclosure frameworks each detail expansive sustainability disclosure requirements – although their scopes and other details vary.

Given the geographic reach of the frameworks and their potential to encompass a broad spectrum of value chain contributors, most companies are expected to be impacted in some way. Proactive companies are in the process of assessing their scope and applicability so that they are prepared to meet potentially short reporting deadlines.

An SEC registrant that has a subsidiary listed in the EU and a subsidiary in a jurisdiction that requires ISSB reporting, for example, might be subject to all three requirements. With equivalency – that is, whether disclosures for one reporting framework can satisfy some or all of the requirements of another – not yet determined, companies captured in multiple reporting regimes have a vested interest in understanding which reporting applies. Further, understanding where the frameworks align and diverge will help companies to develop the requisite reporting strategy, data-gathering processes, and related controls, providing for a streamlined process and effective deployment of resources.

Our in-depth publication (here) compares and contrasts key provisions among the European Sustainability Reporting Standards (ESRS), the standards issued by the ISSB, and the SEC proposal. By understanding the different requirements, preparers can develop the appropriate reporting strategy, one designed to capture the right data the first time.



Regulatory update on ISSB and SEC

ISSB

On 26 June 2023, the ISSB issued its inaugural standards (IFRS S1 and IFRS S2), clearly marking a new era of sustainability disclosures in global capital markets. Shortly after the release of the inaugural standards, the ISSB also issued 'Ten things to know about the first ISSB Standards' and a podcast, and recorded two webinars providing a detailed overview of IFRS S1 and IFRS S2. For more detail regarding these standards and PwC's observations regarding some of these requirements, read our In depth here. For a short overview of IFRS S1 and IFRS S2, read PwC's In brief here.

SEC

While the SEC is focused on the current application of existing securities laws with regard to climate-related disclosures, the exact date of the SEC's final rule on climate-related disclosure is still unknown. The SEC also intends to issue a proposal on human capital management disclosures, which is expected in the second half of 2023.

Other regulations

The EU Taxonomy: the European Commission has published the final delegated acts as part of its sustainable finance package

On 13 June 2023, the European Commission (EC) published its sustainable finance package 2023 including:

- The final Environmental Delegated Act, which defines the technical screening criteria of the four other environmental objectives of the Taxonomy Regulation ('Environmental Delegated Act'), namely:
  - sustainable use and protection of water and marine resources;
  - transition to a circular economy;
  - pollution prevention and control; and
  - protection and restoration of biodiversity and ecosystems.
- Changes to the Disclosures Delegated Act, including the content of the mandatory reporting templates (as part of the Environmental Delegated Act).
- Amendments to the Climate Delegated Act, covering the climate-related environmental objectives of climate change mitigation and climate change adaptation including modifications and new activities.

These delegated acts have been adopted by the EC and were formally adopted since the European Parliament and the Council of the European Union did not object during the scrutiny period that ended on 27 October 2023.

Other parts of the sustainable finance package with relevance for the EU Taxonomy include, inter alia:

- a Commission notice (FAQ document) on the minimum safeguards and links to the Sustainable Finance Disclosure Regulation (SFDR); and
- staff working documents on improving the usability of the Taxonomy and on the Environmental and Climate Delegated Acts.

Find out more about the delegated acts, including the timeline for their application, in our In brief here.

The EU green bond standard: a gold standard for green bonds

The green bond market

The European and global green bond market has been growing by an average of 50% per year in the period 2015–2020 (see Annex 5 to the Commission Impact Assessment). It is set to reach USD1 trillion of yearly global issuance in 2023, with Europe becoming the global leader, as outlined by the Climate Bonds Initiative (here). However, there is a need for more rapid growth of a high-quality green bond market to achieve the targets in the Paris Agreement, as explained in the European Parliament's briefing on green bonds legislation (here).

Despite the increasingly important role that green bonds play in financing assets needed for the transition to a low-carbon economy, there is no uniform green bond standard within the EU. Currently, the global bond standards, frameworks and principles comprise a patchwork of voluntary arrangements. Generally, underlying definitions of green projects are insufficiently standardised and, since assurance is voluntary, the standards do not always adequately ensure transparency and reliability.

What is a green bond?

A green bond is a type of fixed-income instrument that is specifically earmarked to raise money for climate and/or environmental projects. The purpose of green bonds is to provide investors with accessible means to invest sustainably.

How will it be used and who is concerned?

The TEG on Sustainable Finance proposed that the EU GBS should be a voluntary standard proposed to issuers that wish to align with best practices in the market. It is designed to be relevant and accessible to issuers located in the EU as well as to issuers located outside the EU.

Example: Company A develops, constructs and operates wind farms. It is planning to build a portfolio of six facilities, amounting to 500MW, and it looks for financing sources. Since a wind farm is a physical green asset, company A is looking to diversify its financing sources and plans to issue a green bond.

The EU's response

As a part of the Action Plan on Sustainable Finance, adopted by the European Commission (EC) in March 2018, the Technical Expert Group (TEG) on sustainable finance published its recommendations on a voluntary EU Green Bond Standard (EU GBS) in June 2019. In July 2021, the EC published its proposal for a Regulation on European green bonds (the 'EU GBS'). Currently, the European Parliament, EC and the Council of the European Union are in the final phase of three-way negotiations of the proposed EU GBS. The legislation is expected to enter into force in 2023–2024.

With the EU GBS, the EC aims to bridge the gap between the rising investor appetite for sustainable opportunities and the significant investments needed to finance the objectives of the Green Deal, improving transparency, credibility and effectiveness of the green bond market.

Deep dive: understanding the interplay between the EU GBS and other legislation

The EU GBS proposal is part of the EU's broader strategy to foster sustainable finance as projected by the EC's Action Plan on Financing Sustainable Growth from 2018.

Link to Taxonomy: Taxonomy is at the heart of EU GBS projects' eligibility definition. The definition of 'green' is linked to the Taxonomy Regulation and CSRD, which aims to introduce mandatory EU sustainability reporting standards for approximately 50,000 undertakings. A core component of the EU GBS is full alignment of the use-of-proceeds (that is, the financed activities) with the EU Taxonomy, effectively ensuring that the proceeds only finance projects that are aligned with the requirements of 'green activities' set out in the EU Taxonomy.

Link to Sustainable Finance Disclosure Regulation (SFDR): The focus of the EU GBS proposal on transparency requirements connects to SFDR, which stipulates transparency duties for financial market participants and financial advisers on sustainability-related information.

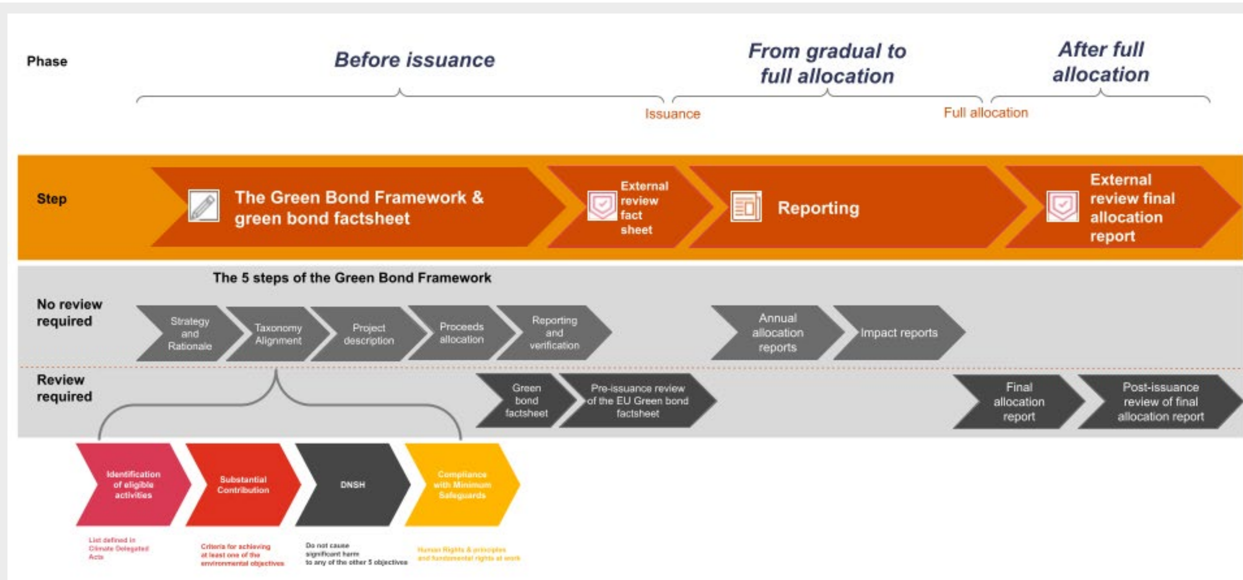
Deep dive: understanding the proposed EU GBS Regulation

Title II, chapter I of the Regulation covers the bond-related requirements. Importantly, all proceeds must be used to finance economic activities that meet the requirements set out in the Taxonomy Regulation, namely: the activity makes a substantial contribution to one of the six environmental objectives, does not significantly harm (DNSH) other environmental objectives, and complies with Minimum Safeguards (MS).

Title II, chapter II covers transparency and external review. It includes specific disclosure requirements as listed below. All disclosures must follow specific templates provided by the Regulation.

- **Green bond fact sheet.** Prior to issuance, the green bond fact sheet must be completed with a qualified assurance opinion (pre-issuance review).The fact sheet includes information around intended allocation of proceeds, intended qualifying green projects, and alignment with the EU Taxonomy.
- **Annual allocation reports.** The EU green bond annual allocation report must be made available each year until full allocation of the proceeds, no later than three months after the end of the year to which it refers. Only the final allocation report requires external verification by an independent auditor.
- **Impact report.** The impact report (Annex III) must be published at least once at full allocation of proceeds and should clearly specify the metrics, methodologies and assumptions applied in the assessment of environmental impacts. The impact report requires no external verification.
- **Green Bond Framework.** The Green Bond Framework is a reporting tool for issuers to explain to investors and other market participants their approach, including the green features of underlying projects or activities, the fit with the issuer's overall strategy, management process, reporting, and plans for external review.

The process of a bond issuance under the EU GBS is illustrated below.



Assurance

Independent external verification is designed to increase reliability and trust in the market by ensuring that green bonds meet the specific and published criteria over their lifecycle.

It is common market practice for green bond issuers to contract a third party to review the green bond documentation prior to bond issuance (to check alignment of the bond framework against the respective standard) and/or post-issuance (to check alignment of net proceeds spent against the Green Bond Framework). In the current green bond market, different types of verifications can be

observed:
(1) Second party opinions (‘SPOs’): An SPO entails an assessment of the alignment of the issuer’s green, social or sustainability bond framework with the relevant Principles. In particular, an SPO includes an assessment of the issuer’s overarching objectives, strategy, policy and/or processes relating to environmental, social or sustainability bond issuance.

(2) *Certification*: An issuer can have its green, social or sustainability bond certified against a recognised external green, social or sustainability standard. A standard such as EU GBS defines specific criteria, and alignment with such criteria (and, for EU GBS in particular, alignment with the EU Taxonomy) and is normally tested by qualified, accredited third parties, which might verify consistency with the certification criteria.

(3) *Green/social/sustainability ratings*: The output of any external review might include a focus on environmental and/or social performance data/process relative to the Principles, or another benchmark, such as a 2-degree climate change scenario. Such scoring/rating is distinct from credit ratings, which might nonetheless reflect material environmental/social/sustainability risks.

(4) *Verification*: Verification focuses on the alignment with internal and external standards or claims made by the issuer.

The types of verification differ in the level of confidence that they provide, as illustrated by the graphic below. These verifications are offered by a range of providers including rating agencies, accounting/audit firms or other service providers.

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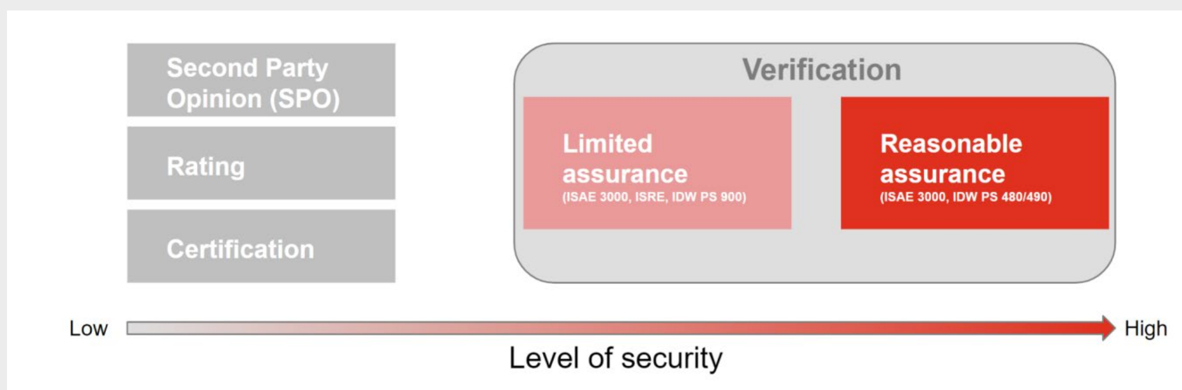


The EU GBS mandates an independent external review (by an independent auditor) of the pre-issuance green bond fact sheet and the final allocation report. A verifier should align with the requirements of the EU GBS and needs to be accredited by the European Securities and Markets Authority (ESMA).

Next steps towards regulation

On 5 October 2023, the European Parliament adopted the provisional agreement on the EU GBS. On 23 October 2023, the Council adopted the Regulation. Now that both co-legislators have formally approved the final text, the Regulation will be published in the Official Journal of the European Union and will enter into force on the 20th day following its publication. The EU GBS will apply 12 months after its entry into force.

Conclusion

Green bonds are an important instrument in the transition, because they lead to emission reductions by issuing firms. EU GBS is the highest standard for green bonds, both in terms of quality (taxonomy alignment) and in terms of assurance.

ESG ratings: the European Commission publishes a proposal for a Regulation to strengthen their reliability

On 13 June 2023, the European Commission (EC) published a proposal for a Regulation on the transparency and integrity of environment, social and governance (ESG) rating activities, thereby completing its plan for sustainable finance in the European Union. This proposal is designed to strengthen the reliability of ESG ratings, to enable investors to make more informed investment decisions and more effectively redirect investments towards sustainable assets. Currently, the activities of ESG rating providers are not subject to any regulation by Member States.

What is the scope?

Under the proposed Regulation, ESG rating providers operating in the EU would be subject to the new rules. Financial institutions would not be subject to the new Regulation, nor would market players developing ESG ratings for their own needs or use.

The proposed Regulation defines an ESG rating as:

- an opinion, a score or a combination of the two provided to third parties,
- based on a well-established methodology and a defined ranking system of rating categories,
- and related to the ESG profile, ESG characteristics, exposure to ESG risks, or impact on people, society and the environment of an entity, financial instrument, financial product or company.

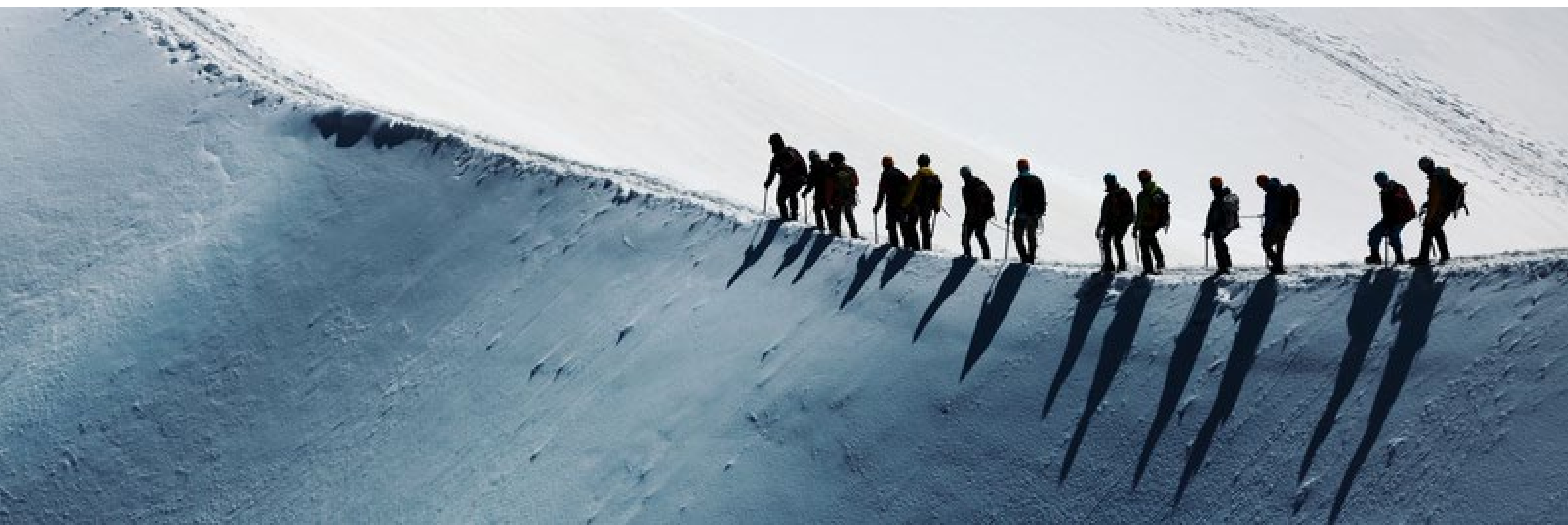
What measures should be taken?

To improve the reliability of ESG ratings, the EC's proposal includes transparency requirements on the methods, models and main assumptions used by ESG rating providers.

It is important to highlight that this proposal is not about standardising the ratings but about improving the transparency of the methods applied.

1. The proposed Regulation stipulates that ESG rating providers should publish the following information on their websites:

- Rating methods used (and their modifications).
- Data processing (source of data: public or non-public; from sustainability reports; estimates of underlying data in the event of unavailability; frequency of data updates).
- Rating objectives (indicate whether the rating assesses risks or impacts, or both).
- Scope of rating: is it an aggregate rating (aggregation of E, S and G factors), or a rating of individual factors or specific issues (for example, transition risks)?
- Within the E, S or G factors, indication of the themes covered by the ESG rating/score and their correspondence with the themes covered by the European Sustainability Reporting Standards (ESRS).



2. Additional information would have to be provided by suppliers to ESG rating subscribers and rated companies falling within the scope of Directive 2013/34/EU ('the Accounting Directive'), including:

- more detailed overview of the scoring methods used (scientific evidence, retrospective or prospective, relevant KPIs for E, S and G factors, method revision policies);
- more detailed overview of data-related processes (more detailed explanation of data sources used, including whether they come from reports published in accordance with the ESRS, taxonomy or SFDR; data quality controls; explanation of estimation methodology in the event of data unavailability, data update and historical data revision policies, date of latest data updates, etc.);
- relations with rated companies; and
- explanation of any artificial intelligence methodology used in the data collection or rating process.

The draft Regulation also suggests a series of measures designed to boost investor confidence, including the introduction of:

- an approval procedure for ESG rating providers and their supervision (these tasks would be entrusted to ESMA);
- strict rules governing the independence of providers and the management of conflicts of interest (prohibition on offering a certain number of other services, including advisory services, credit ratings, benchmark index, etc.); and
- a solid governance system, including a clear organisational structure with a clear division of roles and responsibilities.

Next step

The draft Regulation is currently being examined by the European Parliament.

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