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SUSTAINABLE FINANCE

Sustainable finance is finance that considers the environmental, social and governance (ESG) impacts of financial products and services. Sustainable finance aims to contribute to the transition to a green economy in Europe, in line with the objectives of the Paris Agreement and the European Green Deal.

NAVIGATING THE COMPLEX WORLD OF SUSTAINABLE FINANCE IN THE EUROPEAN UNION

The European Union has developed several legislative initiatives to promote and regulate sustainable finance, including the European taxonomy, the SFDR and the CSRD.

These initiatives have implications for companies and investors, who need to adapt their businesses to the new ESG requirements, as well as sustainability reporting and disclosure, in force since January 1, 2024.

European taxonomy

The European taxonomy is a classification system that defines which economic activities are environmentally sustainable, in line with the objectives of the Paris Agreement and the European Green Deal. The European taxonomy aims to facilitate and encourage sustainable investment, avoiding greenwashing and increasing the transparency and accountability of financial institutions.

The European taxonomy establishes six environmental objectives, namely: (i) Mitigation of climate change; (ii) Adaptation to climate change; (iii) Sustainable use and protection of water and marine resources; (iv) Transition to a circular economy; (v) Pollution prevention and control; and (vi) Protection and restoration of biodiversity and ecosystems.

> *"Sustainable finance in the European Union is an unavoidable reality."*

For an economic activity to be considered sustainable, it must contribute significantly to at least one of these objectives, without causing significant damage to the others, and comply with minimum standards of social governance. The European taxonomy also establishes specific technical criteria for each economic activity, which must be followed by companies and investors.

The European taxonomy brings several benefits for companies, such as: (i) Improving their reputation and competitiveness; (ii) Attracting more investors interested in sustainability; (iii) Reducing environmental and social risks; and (iv) Alignment with European Union policies and regulations.

However, the European taxonomy also imposes several challenges, such as: (i) Defining what a sustainable investment is; (ii) Obtaining and managing the necessary ESG data; (iii) Producing and updating disclosure documents; (iv) Communicating sustainability information clearly and effectively; and (v) Establishing and monitoring an internal control environment.

SFDR

The SFDR stands for Sustainable Finance Disclosure Regulation, which is a European Union law that aims to increase the transparency and accountability of financial institutions on the ESG impacts of their products and services. The SFDR complements the European taxonomy by establishing the rules and standards for sustainability disclosure.

The SFDR represents a challenge for asset managers, who need to adapt their operating models, policies, and processes to comply with the new disclosure requirements. Some of the main challenges are: (i) Defining what a sustainable investment is, according to the SFDR criteria and the European taxonomy; (ii) Obtaining and managing the ESG data needed to calculate and report adverse impact indicators, which are the metrics that measure the negative effects of investments on sustainability factors; (iii) Producing and updating pre-contractual documents, which are the standardized templates that present the sustainability information of financial products; (iv) Communicate sustainability information clearly and effectively to investors, avoiding greenwashing, which is the practice of exaggerating or falsifying the ESG credentials of a product or service; (v) Establish and monitor a control environment, involving the risk, compliance and product functions, to ensure compliance with SFDR standards and good practices.

CSRD

The CSRD stands for Corporate Sustainability Reporting Directive, which is a new European Union law that requires all large and listed companies to publish regular reports on their environmental and social impact activities. The CSRD aims to increase the transparency and accountability of companies about the ESG impacts of their products and services. This will help investors, consumers, policymakers, and other stakeholders to assess the non-financial performance of companies, as part of the European Green Deal.

The CSRD entered into force on January 5, 2023 and replaces the previous Non-Financial Reporting Directive (NFRD). The CSRD extends the scope of companies subject to sustainability reporting obligations from around 11,000 to around 49,000 in the European Union. The CSRD also establishes that companies must report in accordance with the European Sustainability Reporting Standards (ESRS), which were developed by EFRAG, an independent body that brings together various stakeholders. The ESRS were published in the Official Journal on December 22, 2023 in the form of a delegated regulation.

The CSRD also requires that the sustainability information that companies report be subject to assurance by a statutory auditor and provides for the digital taxonomy of sustainability information. The first companies will have to apply the new rules for the first time in the 2024 financial year, for reports to be published in 2025.

The CSRD represents both a challenge and an opportunity for companies, which need to adapt their operating models, policies, and processes to comply with the new reporting requirements. The CSRD brings benefits for companies, such as improving their reputation and competitiveness, attracting more investors interested in sustainability, reducing environmental and social risks, and alignment with EU policies and regulations.

The CSRD is an important tool for the transition to a green economy in Europe, which requires the collaboration and adaptation of all sectors and economic agents.

ESRS

The ESRS are a set of standards that define the contents, formats, and methods for the disclosure of sustainability information by companies, in accordance with the Corporate Sustainability Reporting Directive (CSRD). The ESRS were developed by EFRAG, an independent body that brings together various stakeholders such as regulators, auditors, investors, companies, and civil society organizations. The ESRS were published in the Official Journal of the European Union on December 22, 2023, in the form of a delegated regulation.

The ESRS include two types of standards: cross-cutting standards and sectoral standards. Cross-cutting standards apply to all companies, regardless of their sector of activity, and cover the three pillars of sustainability: environment, social and governance. The cross-cutting standards include two general standards, which define the principles and process of sustainability reporting, and the thematic standards, which define the indicators and criteria for each of the sustainability factors. The sectoral standards are applicable to companies in specific sectors, which have sustainability impacts or risks, and complement the transversal standards with additional indicators and criteria. The sectoral standards are still under development and will probably be published in 2025.

The ESRS have several benefits for companies, such as: (i) Improving their transparency and accountability; (ii) Attracting more investors interested in sustainability; (iii) Reducing reporting costs and complexities; and (iv) Aligning with European Union policies and regulations.

However, ESRS also entail several challenges, such as: (i) Obtaining and managing the necessary sustainability data; (ii) Ensuring the quality and reliability of sustainability information; (iii) Integrating sustainability information with financial information; and (iv) Establishing and monitoring an internal control environment.

Therefore, ESRS are an important tool for the disclosure of sustainability information by companies, which must be aware of and prepared for the new reporting requirements.

Credit institutions and insurance companies

Basel III and Solvency II do not yet explicitly incorporate ESG criteria, which are increasingly relevant for assessing the risk and performance of credit institutions and insurance companies, respectively. The European Union is therefore working on changes to these rules to make them sensitive to ESG criteria, in line with its sustainable finance initiatives, such as the European taxonomy, the SFDR and the CSRD.

The changes to Basel III and Solvency II to make them sensitive to ESG criteria are aimed at the following: (i) Encourage credit institutions and insurance companies to integrate ESG factors into their strategy, governance, culture and decision-making processes; (ii) Reflect the risks and opportunities associated with ESG factors when calculating the capital requirements of credit institutions and insurance companies, taking into account stress scenarios and long-term perspectives; (iii) Promote the disclosure of sustainability information by credit institutions and insurance companies in a consistent, comparable and reliable manner, following European sustainability reporting standards and digital taxonomy; (iv) Align prudential rules with the European Union's environmental and social objectives, supporting the transition to a green economy and the realization of the European Green Deal.

Non-financial companies

Non-financial companies are largely small and medium-sized enterprises (SMEs), which represent around 99% of the European Union's businesses and make a decisive contribution to economic growth, innovation, and employment. SMEs are also affected by the European Union's sustainable finance initiatives, such as the European taxonomy, the SFDR and the CSRD, both because they are in the value chain of large companies and because of the implications for access to finance and insurance.

Non-financial companies face various challenges and opportunities in the context of sustainable finance in the European Union.

On the one hand, non-financial companies can benefit from greater access to sustainable finance, which offers better conditions for projects that meet ESG criteria and contribute to the European Union's environmental and social objectives. Non-financial companies can also improve their reputation and competitiveness by demonstrating their commitment to sustainability and aligning themselves with the expectations of their customers, suppliers, employees, and other stakeholders. In addition, non-financial companies can reduce their environmental and social risks by adopting more efficient and resilient practices that enable them to save resources, reduce emissions, prevent pollution, protect biodiversity, and promote social well-being.

On the other hand, non-financial companies also face various challenges and costs in adapting to the new sustainability reporting and disclosure requirements, which involve greater complexity and bureaucracy. Non-financial companies may find it difficult to obtain and manage the ESG data needed to demonstrate their performance and impact, as well as to guarantee its quality and reliability. Non-financial companies may also find it difficult to communicate their sustainability information clearly and effectively, avoid greenwashing and comply with European sustainability reporting standards and digital taxonomy. In addition, non-financial companies may have difficulties integrating ESG factors into their strategy, governance, culture, and decision-making processes, as well as establishing and monitoring a control environment involving the risk, compliance, and product functions.

Therefore, non-financial companies must be aware of and prepared for the impacts of sustainable finance in the European Union, which can represent both challenges and opportunities for their development and their contribution to a green and inclusive economy.

"Sustainable finance is therefore an opportunity."

In conclusion...

☐ Sustainable finance in the European Union is an unavoidable reality, which requires a paradigm shift and a change in attitude on the part of all economic agents.

☐ It's not just a question of complying with standards and regulations, but of incorporating the values and principles of sustainability into the essence of business.

☐ Those who fail to adapt run the risk of falling behind, losing competitiveness and relevance, and compromising the future of the planet and future generations.

☐ Sustainable finance is therefore an opportunity and a responsibility that must be taken seriously, rigorously and innovatively.

☐ The question is not whether we will adhere to sustainable finance, but how and when we will do so.

Time is running out and action is needed. Are we ready?

ATLAW Azevedo Lopes Lawyers
Avenida 5 de Outubro, 359C - Piso 1 – Escritório 4
T: +351 211 358 201
E: info@atlaw.pt - www.atlaw.pt