2024 ESG Regulatory Updates

Implications for Fixed Income Investors

This whitepaper explores the evolving landscape of Environmental, Social, and Governance (ESG) regulations in the fixed income investment sector, focusing on key updates set to take effect this year. Specifically, it examines the EU Taxonomy and EU Green Bond Standard and their implications for asset managers and Article 9 funds under the EU Sustainable Finance Disclosure Regulation (SFDR).

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Overview of the Global ESG Regulatory Environment

The Environmental, Social, and Governance (ESG) regulatory environment has experienced significant growth and evolution in recent years. Governments and financial regulatory bodies around the world have recognised the importance of ESG considerations in investment decision-making and the need for standardisation and transparency in ESG reporting.

Historically, ESG has not been regulated, which has led to the term being used loosely and manifesting different meanings[1]. Currently, over half of the green claims given are vague and misleading and 40% of all claims have no supporting evidence.

ESG regulations aim to promote sustainable and responsible investment practices. They require companies and financial institutions to consider and disclose ESG factors in their operations, investment strategies, and reporting. These regulations are designed to address concerns related to climate change, social issues, corporate governance, and ethical business practices.

The ESG regulatory landscape is dynamic, with varying degrees of maturity across regions. Some regions, like the European Union, have taken a leading role in developing comprehensive ESG regulations, such as the Sustainable Finance Disclosure Regulation
(SFDR), EU Taxonomy Regulation, and the EU Green Bond Standard. Other regions, including the United States and Asia, are also increasing their focus on ESG regulation and disclosure requirements.

The current year of 2024 will mark a significant year for EU ESG regulations, with new regulations that will impact various aspects of the investment landscape, including fixed income investments. Fixed income investors will need to navigate these evolving regulatory frameworks, integrate ESG factors into their decision-making processes, and adapt to the changing expectations of stakeholders and regulators

European ESG Regulatory Landscape

The Corporate Sustainability Reporting Directive (CSRD) came into effect in January of this year, which means that it has broadened the scope of companies who are required to start reporting on their sustainability efforts. Under CSRD, companies have to make E, S & G disclosures against EU corporate sustainability reporting standards, including own operations and value chain, material risks and impacts. These disclosures have been integrated with the EU Taxonomy alignment from a content and timing perspective and provides welcomed information to investors, who have previously been struggling to report about the companies in their portfolios in accordance with SFDR.

The purpose of SFDR is to provide greater transparency around ESG products sold to consumers and institutional investors in the EU. The goal is to clearly define the products offered and to understand how ESG is implemented in the investment strategy.

SFDR categorises investment strategies to Article 6, 8 or 9. Article 6 funds do not include any sustainability concerns, while Article 8 promotes environmental and social considerations. To qualify as an Article 9 fund, a strategy needs to target sustainable investments and its reference benchmark also needs to reflect this approach.

1 Source: https://environment.ec.europa.eu/topics/circular-economy/green-claims_en

Current State of the Sustainable Bond Market

Despite of having established EU Taxonomy and their environmental objectives in 2020, there are still concerns around the alignment of green with issuers. According to Climate Bonds Initiative, which certifies green bonds, the problems are especially prevalent in the sustainability-linked bond (SLB) space.

"Around three-quarters of the sustainability-linked bonds assessed by the non-profit, Climate Bonds Initiative, do not 'cut the mustard' in terms of quality."[2] This can be viewed in the figure below.

The SLB space will also continue to develop with more stringent recommendations around setting of key performance indicators (KPIs) and transparency into terms of the bonds, including coupon adjustment.

Use of proceeds green bonds have fewer problems, but there are still situations where the proceeds of these bonds finance, for example, coal or gas power, without a clear transition plan. In their October 2023 report, International City/County Management Association (ICMA) raised the following key areas of concern:[3]

- Some projects in use of proceeds frameworks lack ambition and do not fulfil the definition of green or sustainable.
- Mismanagement of wider sustainable risks, including lack of processes to identify possible risks and trade-offs presented by the bond frameworks.
- Strategic inconsistency between what the issuer does as a whole versus what the purpose of the green, social, or sustainable bond is.

Sustainable Bond Investors and SFDR

For fixed income investors aiming for the Article 9 classification, many investors are heavily utilising use of proceed green, social, or sustainable bonds to meet the requirement of sustainable investment. Where the market still differs and has different opinions is whether SLBs are valid instruments in Article 9 funds. Given the current challenges in measuring the impact of SLBs and how they are driving the sustainability goals of issuers, some investors think that it is impossible now to prove they are serving their role to target sustainable investments. In 2023, differing opinions were shared with the market in a Nordic Sustainable Investment Platform (Nordsip) blog.[4] Nordic regulators have not yet taken an official stance on if, in their opinion, Article 9 funds may include SLBs, but the indication is that with proper due diligence and analysis, an asset manager could fulfil the requirements set by this classification.

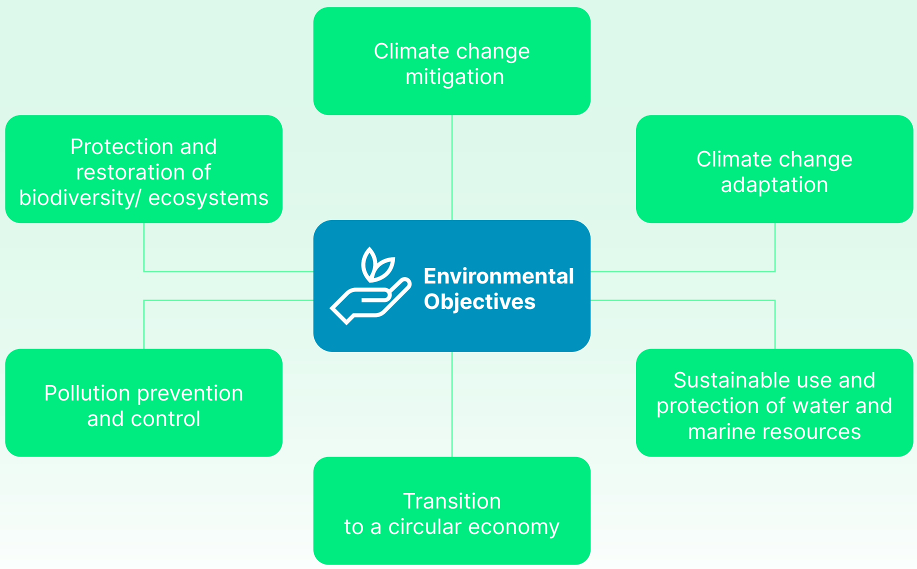
2 https://www.ft.com/content/6edcca0e-c89d-47f2-8d67-f6896b1606f4

3 https://www.icmagroup.org/News/news-in-brief/icma-releases-new-paper-on-market-integrity-and-greenwashing-risks-in-sustainable-finance/

4 https://nordsip.com/2023/05/26/are-slbs-the-right-shade-of-green-for-article-9-funds/

Clearly Defining Environmentally Sustainable Economic Activities through EU Taxonomy

EU Taxonomy provides an EU-wide framework in which investors and companies can assess whether certain economic activities are environmentally sustainable. Only certain economic activities are covered by the taxonomy, and it includes only green economic activities. The EU social taxonomy is currently being created, and a release date has not been established.



Climate change mitigation and climate change adaption are the only two objectives that have been fully developed and have technical screening criteria available. For the remaining four, technical screening criteria is set to take effect this year.

To qualify as environmentally sustainable, an economy activity must fulfil the following criteria:

1. Substantially contribute to one of the six environmental objectives
2. Do no significant harm (DNSH) to other five objectives
3. Be carried out in accordance with minimum social and governance safeguards

Lack of data has created some of the challenges to evaluate DNSH across the taxonomy. Minimum safeguards have also lacked clarity. A recent report by the advisory body EU Platform on Sustainable Finance stated that lack of taxonomy alignment can be found around four core topics, including human rights, bribery, taxation, and fair competition.

For bond investors, EU Taxonomy was initially only presented on the company level for the pool of bonds in an issuer's portfolio. Per recommendations set by the European Securities and Markets Authority (ESMA) in May 2023, an issuer should present their EU Taxonomy reporting on a bond level for the greatest granularity. This is providing the issuer with the greatest transparency into which economic activities bond proceeds are being used for.

EU Green Bond Standard Setting a High Bar for Issuers

EU Green Bond Standard is a voluntary label that requires that the bond be fully aligned with the EU Taxonomy. There is a 15% flexibility pocket to allow some exceptions outside of the 100% green use of proceeds, but these exceptions may be difficult to meet. Net proceeds must be allocated according to the taxonomy requirements. The bond will also have to allocate proceeds towards one or more of the following: fixed assets, capital expenditure, operating expenditures, financial assets, and assets/expenditures of households.

The purpose of the label is to provide added transparency. The label is overseen by ESMA, who maintains a public registry of all bonds adhering to EU Green Bond standards. To qualify, the issuer needs to fill out the EU Green Bond fact sheet and seek external party opinion. After issuance, the issuer needs to complete a standardised Green Bond allocation and impact report and attain external reviewer assurance. ESMA supervises to ensure issuers meet the set criteria pre- and post-issuance.

EU Green Bond Standard provides investors with assurance that issuers are fully aligned with EU Taxonomy. The standardised templates also make it easier for investors to report on their bonds both on an issuer and portfolio level.

Conclusion

This whitepaper delves into the dynamic landscape of ESG regulations, particularly focusing on the EU Taxonomy and EU Green Bond Standard, set to impact fixed income investors this year. Key takeaways include the increasing global recognition of ESG considerations, the evolving nature of regulatory frameworks, and the challenges faced in achieving sustainability goals, especially in the sustainable bond market.

Investors, particularly those aiming for Article 9 classification, are navigating the complexities of diverse instruments, from use of proceeds green bonds to SLBs. Challenges persist, including concerns about impact measurement and strategic inconsistency. The report underscores the critical role of due diligence and analysis in meeting the requirements for sustainable investments.

Looking Ahead to the Evolving ESG Landscape

This year will be a pivotal year for EU ESG regulations, the spotlight is on CSRD and its broadened scope, influencing E, S & G disclosures. The SFDR categorises investment strategies, emphasising transparency around ESG products. The sustainable bond market faces challenges, prompting a closer examination of use of proceeds frameworks and the need for improved industry alignment.

The EU Taxonomy emerges as a cornerstone for evaluating environmental sustainability, emphasising the significance of fulfilling criteria, avoiding harm, and adhering to social and governance safeguards. The EU Green Bond Standard, a voluntary yet robust label, sets a high bar for issuers, ensuring alignment with the EU Taxonomy and providing transparency through standardised reporting.

In conclusion, this year fixed income investors must proactively adapt to these evolving regulatory landscapes, ensuring alignment with sustainability goals, transparency in reporting, and strategic decision-making to navigate the intricate ESG terrain. The commitment to due diligence and adherence to these evolving standards will play a crucial role in shaping a sustainable and responsible investment future

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