SUSTAINABLE FINANCE — THE APRIL 2021 PACKAGE

Just one day prior to Earth Day and a US-led global climate summit, the European Commission (EC) adopted on 21 April 2021 an ambitious and comprehensive package of measures to help improve the flow of money towards sustainable activities across the European Union (EU).

By enabling investors to re-orient investments towards more sustainable technologies and businesses, the EC sees these measures as being instrumental in making Europe climate neutral by 2050, as well as making the EU a global leader in setting standards for sustainable finance.

The EC’s April 2021 sustainable finance package includes the following:

- The EU Taxonomy Climate Delegated Act¹ (providing details on the EU Taxonomy Regulation (EU TR) screening criteria for climate change);

- A proposal for a new Corporate Sustainability Reporting Directive (CSRD)², revising the Non-Financial Reporting Directive (NFRD)³; and

- Amendments on ESG rules covering sustainability preferences and fiduciary duties amending the current UCITS, AIFMD, MiFID II and insurance regimes.⁴

We look at each of these in more detail below.
**EU Taxonomy Regulation and the EU Taxonomy Climate Delegated Act**

The EU TR entered into force on 12 July 2020⁵ and the EC states that it will help create the world’s first ever ‘green list’ – a classification system for environmentally sustainable economic activities. It aims to create a common language that investors can use when investing in projects and economic activities that have a substantial positive impact on the climate and the environment.

Disclosure obligations are defined in the EU TR.

The EU Taxonomy Climate Delegated Act (April DA) defines the technical screening criteria for economic activities that can make a substantial contribution to climate change mitigation and climate change adaptation – aligned for purposes of these disclosure obligations.⁶

Whilst the April DA itself is only 23 pages long, the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives laid down in Article 9 of EU TR are set out in Annex I.⁷

The technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change adaptation and for determining whether the economic activity causes significant harm to any of the environmental objectives laid down in Article 9 of the same EU TR is set out in Annex II.⁸ Both of which are substantially longer documents.

The April DA will be formally adopted at the end of May 2021 and will apply from 1 January 2022.

The EC say that the disclosure by companies of Taxonomy-aligned green activities should mean there is more reliable, comparable sustainability information publicly available on the market for investors and stakeholders. Financial market participants can, if they wish, use the EU Taxonomy to design credible green financial products. However, there is no obligation for companies to be Taxonomy-aligned and investors will be free to choose what to invest in.

The April DA is a living document and will continue to evolve over time, with more activities being added to its scope by means of amendments. It will also be able to reflect technological progress.

A complementary Delegated Act will also be adopted later in 2021 on agriculture and certain energy sectors not yet included in the April DA.

In addition, another Taxonomy Climate DA will focus on activities making a substantial contribution to the other four environmental objectives.⁹
Nuclear power
Nuclear power is not currently mentioned in the April DA, but the EC have said that this will be addressed in a complementary DA further down the line, subject to and consistent with the results of a specific review process underway in accordance with the EU TR.

In 2020, the EC launched in-depth work to assess whether nuclear power should be included or excluded from the EU TR. As a start the Joint Research Centre drafted a technical report on the ‘do no significant harm’ aspects of nuclear energy. The report is currently being reviewed by two sets of independent experts, the Group of Experts on radiation protection and waste management under Article 31 of the Euratom Treaty and the Scientific Committee on Health, Environmental and Emerging Risks.

The two Committees will have three months to issue their assessment, which in turn will inform the EC’s future decision.

Natural gas
The April DA neither includes nor excludes natural gas. The complementary DA will cover natural gas and related technologies as transitional activity in as far as they fall within the limits of the EU TR.

In addition, the EC will consider specific legislation covering the gas activities that contribute to reduce greenhouse gas emissions, but cannot be covered by the EU Taxonomy, as they do not meet the screening criteria.

So more to come.

Bioenergy and forestry
The April DA foresees that the EC will review the screening criteria for both bioenergy and forestry based on upcoming EC policies and taking into account legislation, in accordance with the biodiversity and climate neutrality ambitions of the EU. A review will happen at the same time as the issuance of the future DA on the biodiversity objective.

Agriculture sector
It was decided to remove the criteria on this occasion for agriculture activities from the April DA pending further progress on the negotiations underway on the Common Agricultural Policy, and in order to achieve greater coherence across the different instruments to achieve the environmental and climate ambitions of the European Green Deal.

Hydropower
The criteria for hydropower have been made more context-specific in the April DA. A careful alignment had to be found between the requirements of the EU TR, notably the ‘do no significant harm’ requirements, and the requirements of existing law, such as the Water Framework Directive.
Hydrogen

The April DA fully recognises the multiple low-carbon applications and uses of hydrogen as an energy carrier, storage solution, fuel or feedstock. The criteria for manufacturing hydrogen are set at a level considered sufficiently ambitious to ensure a substantial contribution to climate change mitigation, favouring the production of hydrogen from renewable sources. For this reason, the criteria go beyond the recommendations of the Technical Expert Group.

Cooperation at an international level

International cooperation is key to developing common global standards in sustainable finance. Very few countries have thus far developed detailed, science-based criteria, with the notable exceptions being the EU and China. However, others are in the process of developing them. To deal with this, the International Platform on Sustainable Finance (IPSF) has started a working group on taxonomies, co-chaired by China and the EU to undertake a comprehensive assessment of existing taxonomies developed by public authorities of its member countries. This work will result in a Common Ground Taxonomy to display common features of existing taxonomies, starting with China and the EU. This would form a basis to develop common sustainable activities (i.e. taxonomies), through the IPSF and other forums such as the G7, G20 and the Financial Stability Board.

Corporate Sustainability Reporting Directive

The reporting rules introduced by NFRD established important principles for certain large companies to report sustainability information on an annual basis. It introduced a ‘double materiality perspective’. The EC say that evidence suggests that the information that companies report is not sufficient, with such information being difficult to compare from company to company. Lack of quality in this reporting also has knock on effects meaning that investors can lack a reliable overview of sustainability-related risks to which companies are exposed. This is why the EC has proposed the CSRD, which will ultimately replace the NFRD.

CSRD scope – more companies

The reporting rules introduced by the NFRD apply to ‘public interest entities.’ Stakeholder feedback to earlier EC consultations identified support in extending the scope to additional categories of companies, whether they are listed or not and without the previous 500 employee threshold. In addition, the EC is proposing to extend the scope to include listed SMEs, with the exception of listed micro-enterprises.

Developing standards

The European Financial Reporting Advisory Group (EFRAG) will be responsible for developing draft standards. Before adopting any standards, the EC will consult with the Member States Expert Group on Sustainable Finance and seek the opinion of the European Supervisory Authorities (ESA’s) and other bodies.

Global standard alignment

The EC states that it is in the interests of the EU and European companies and investors to have standards that are globally aligned. The EC supports initiatives by the G20, the G7, the Financial Stability Board and others to develop a baseline of global sustainability reporting standards that would build on the work of the Task Force on Climate-related Financial Disclosures (TCFD), amongst others.

The proposed EU sustainability reporting standards would build on and contribute to standardisation initiatives at a global level, requiring constructive and two-way cooperation between EFRAG and relevant international initiatives.

Audit assurance

The proposal will for the first time introduce an EU-wide audit (assurance) requirement for reported sustainability information. The EC are proposing to start with a ‘limited’ assurance requirement, representing an advance on the current situation.

The EC’s proposal also allows Member States (MS) to open up the market for sustainability assurance services to ‘independent assurance services providers’, meaning that MS could choose to allow firms other than the usual auditors of financial information to assure sustainability information.
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Digitalisation
The EC’s proposal anticipates the increasing digitalisation of sustainability information. Specifically, the proposal would require companies to prepare their financial statements and their management report in XHTML format in accordance with the ESEF Regulation.17

This in turn will mean that sustainability information can easily be incorporated in the European Single Access Point envisaged in the Capital Markets Union Action Plan, for which the EC will put forward a proposal for later this year.

Co-legislators to negotiate
EFRAG will prepare a first set of draft sustainability reporting standards for consideration by the EC once the European Parliament and Council have agreed the CSRD’s legislative text. EFRAG aims to have the first set of draft standards ready by mid-2022.

The final timetable will depend upon how the European Parliament and Council progress in their negotiations. If they reach agreement in the first half of 2022, then the EC should be able to adopt the first set of reporting standards under the new legislation by the end of 2022. That would mean that companies would apply the standards for the first time to reports published in 2024, covering the financial year 2023.

Amendments to six DAs covering investment and insurance advice, fiduciary duties, and product oversight and governance
The DAs are part of a broader EC initiative on sustainable development. It lays the foundation for an EU framework which puts sustainability considerations at the heart of the financial system to support transforming Europe’s economy into a greener, more resilient and circular system in line with the European Green Deal objectives.

Following the adoption of the 2016 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development Goals (SDGs), the EC announced in the Action Plan: Financing Sustainable Growth19 the intention to clarify the integration of sustainability in so-called fiduciary duties in sectoral legislation. The European Green Deal Communication confirms the need for long-term signals to direct financial and capital flows to green investment and to avoid stranded assets. The DAs contribute to this specific objective.

The six DAs encourage the financial system to support businesses on the path towards sustainability, as well as supporting existing sustainable businesses. They will also strengthen the EU’s fight against greenwashing.

- On investment and insurance advice: when an adviser assesses a client’s suitability for an investment, they now need to discuss the client’s sustainability preferences.

- On fiduciary duties: the amendments clarify the obligations of a financial firm when assessing its sustainability risks, such as the impact of floods on the value of investments.

- On investment and insurance product oversight and governance: manufacturers of financial products and financial advisers will need to consider sustainability factors when designing their financial products.

MiFID II DA
The MiFID II DA20 modifies Delegated Regulation (EU) 2017/565 in two ways. Firstly it integrates clients’ preferences in terms of sustainability as a top up to the suitability assessment. Under the existing MiFID II framework, firms providing investment advice and portfolio management are required to obtain the necessary information about the client’s knowledge and experience in the investment field, their ability to bear losses, and objectives including the client’s risk tolerance to enable the firm to provide services and products that are suitable for the client (suitability assessment).

The information regarding the investment objectives of clients includes information on the length of time for which clients wish to hold the investment, their preferences regarding risk taking, risk profile, and the purposes of the investment. However, the information about investment objectives generally relates to financial objectives, while other non-financial objectives of the client, such as sustainability preferences, are usually not addressed. Existing suitability assessments generally do not include questions on clients’ sustainability preferences, while the majority of clients would not raise such preferences themselves. As a result, investment firms could give more appropriate consideration to sustainability factors in the selection process.

The draft MiFID II DA ensures that financial instruments that have some level of sustainability-related materiality are eligible for recommendation to the clients or potential clients who express clear sustainability preferences.

Second, the MiFID II DA integrates sustainability risks into the organisational requirements. This part on the sustainability risk is based on a Final Report on integrating sustainability risks and factors in MiFID II by ESMA. The technical advice concludes that further clarifications are needed in respect of the integration of sustainability risks and sustainability factors in Delegated Regulation (EU) 2017/565 and Commission Delegated Directive 2017/5939 and identifies specific provisions in this respect.

DA on Product Governance Obligations
Under the existing MiFID II framework, an investment firm which manufactures financial instruments for sale to clients shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or
distributed to clients. The product approval process shall specify an identified target market of end clients within the relevant category of clients for each financial instrument and shall ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.

Further, Article 24(2) MiFID II requires investment firms which manufacture financial instruments for sale to clients to ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients, the strategy for distribution of the financial instruments is compatible with the identified target market, and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market. Chapter III of Delegated Directive (EU) 2017/593 lays down further details on the product oversight and governance process for both manufactures and distributors.

The conditions to identify a target market in Delegated Directive 2017/593 adopted under Articles 16(12) and 24(13) of MiFID II did not yet explicitly establish the details of the integration of sustainability factors and sustainability-related objectives by investment firms manufacturing financial instruments and their distributors. This DA clarifies that sustainability factors and sustainability related objectives should be taken into account in the product oversight and governance process.

**AIFMD and UCITS DAs**

The AIFMD DA and UCITS DA are based on a Final Report on technical advice by ESMA. The technical advice concludes that further clarifications are needed in respect of the integration of sustainability risks and sustainability factors in Regulation 231/2013 and Directive 2010/43/EU and identifies specific provisions in this respect.

The AIFMD and UCITS DAs clarify the current obligation of AIFMs and UCITS to integrate sustainability risks. The clarification does not introduce ranking amongst different risks. The two DAs also clarify some of the implications of regulation on sustainability-related disclosures in the financial services sector, namely where AIFMs or management companies of UCITS disclose information with regard to the consideration of adverse sustainability impacts.

**Other DAs**

The remaining two DAs relate to the integration of sustainability risks in the governance of insurance and reinsurance undertakings and the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products.

**Timing for the DAs**

The amendments on investment and insurance advice, fiduciary duties, and product oversight and governance are subject to scrutiny by the European Parliament and the Council (three month periods and extendable once by three additional months). After this, the Delegated Acts gives 12 months for market participants to implement the requirements. The rules are expected to apply from around October 2022.

**Conclusion**

The elements of the sustainability finance package are the latest policy efforts from the EC looking to give effect to the European Green Deal and to provide a comprehensive framework to assist companies in transforming their business models via enhancing the reliability and comparability of sustainability information.

In the run-up to COP26 in November 2021, we are seeing countries, including the United States and the United Kingdom, as well as the EU, set ambitious climate targets, and there is an increased appetite for sustainable finance products as well as a growing focus on the global convergence of standards.

As mentioned, the EC is clearly hoping that its new sustainable finance package will establish the EU as a global standards leader.
The ESA’s comprise: European Securities and Markets Authority (ESMA), Listed companies, banks and insurance companies. Companies that are large (i.e. they are not SMEs, as defined by the Accounting Directive), and have more than 500 employees.

The April DA lists a number of economic activities in sectors covering the large majority of EU carbon emissions (e.g. manufacturing, buildings, etc.) and sets criteria to determine whether each activity can be considered to make a substantial contribution to climate change mitigation and adaptation. And do no significant harm to environmental objectives.

Annex I covers: Forestry; Environmental protection and restoration activities; Manufacturing; Energy; Water supply, sewerage, waste management and remediation; Transport; Construction and real estate activities; Information and communication; and Professional, scientific and technical activities.

Annex 2 covers: Forestry; Environmental protection and restoration activities; Manufacturing; Energy; Water supply, sewerage, waste management and remediation activities; Transport; Construction and real estate; Information and communication; Financial and insurance activities; Education; and Arts, entertainment and recreation.

These are: the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control and the protection and restoration of biodiversity and ecosystems.

The EC in-house science and knowledge service.

Including the revision of the Renewables Directive.

Meaning that companies have to report about how sustainability issues affect their business and about their own impact on people and the environment.

Listed companies, banks and insurance companies. Companies that are large (i.e. they are not SMEs, as defined by the Accounting Directive), and have more than 500 employees.

Nearly 50,000 companies in the EU will now follow detailed rules under the CSRD, compared to 11,000 companies who were previously subject to the NFRD.

The ESA’s comprise: European Securities and Markets Authority (ESMA), the European Banking Authority (EBA), and the European Insurance and Occupational Pensions Authority (EIOPA), whilst other bodies include the European Environment Agency, the European Union Agency for Fundamental Rights, the European Central Bank, the Committee of European Auditing Oversight Bodies, and the Platform on Sustainable Finance.

Which would also include proposals of the International Financial Reporting Standards (IFRS) Foundation to create a new Sustainability Standards Board and work already carried out by established initiatives including the global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the International Integrated Reporting Initiative (IRRC), the Climate Disclosure Standards Board (CDSB) and CDP.


Supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits.


See https://ec.europa.eu/transparency/regdoc/rep/3/2021/EN/C-2021-2614-F1-EN-MAIN-PART-1.PDF.

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