Europe Jacques Delors
Thinking Europe

Policy paper / October 2020

#EuropeJacquesDelors
#EUGreenDeal #GreenFinance
#ClimateChange

European Green Transparency:

Lessons from France and Further Room Improvement

> *Proposals to improve the Non-Financial Reporting Directive upon its revision in light of France's legislation experience.*

Jean-François Pons and Camille Le Ho, 2020

In December of 2019, European Commission President Ursula von der Leyen announced the flagship project of her mandate –the European "Green Deal"– of which the main objective is to reach climate neutrality by 2050. This ambitious objective implies a **profound transformation of Europe's economy, including changes to the behaviours of companies, households and public authorities** in order to succeed in the fight against climate change, as well as safeguard the transformation towards a circular, environmentally friendly economy.

Among the set of measures that must underpin this transition is the assurance of "green transparency", ***i.e.*** **the reporting of environmental information**, starting with the reporting of company data that concerns the fight against climate change.

This will not only act as an incentive towards the "green" transition, but will also meet the demands of consumers, shareholders and employees, all of whom are increasingly concerned about the environment. In addition, such transparency will allow for the dissemination of data, experiences, and models in a field amidst innovation.

Authors

JEAN-FRANÇOIS PONS
Research Associate, Europe Jacques Delors

CAMILLE LE HO
Research Assistant, Europe Jacques Delors

To ensure "green transparency" at the European Union level, the European Commission has committed to revising the Non-Financial Reporting Directive[1] (NFRD) in 2020 as part of its strategy to facilitate and encourage the financing of sustainable activities[2]. A public consultation was held from February to July 2020 in order to let various stakeholders share their recommendations. The directive states that " the disclosure of non-financial information in respect of certain large undertakings is of importance for the interests of undertakings, shareholders and other stakeholders alike".

Using an example from France via Article 173 of the Energy Transition for Green Growth Act[3] (LTECV), this paper demonstrates how the NFRD is currently insufficient to achieve the environmental objectives set by the European Union. Drawing on several practical cases, it identifies opportunities for improvement and proposes concrete recommendations for better involvement of financial and non-financial companies in the energy transition.

01.

French Article 173: environmental information that is still inadequately comparable

A. France, a pioneer in the reporting of non-financial information

France was the first country in the world to adopt a law requiring "green transparency" as part of its Energy Transition for Green Growth Act. Adopted in 2015, the law became applicable on 1 July 2017 and required backdated data concerning the year 2016. Article 173 of this law requires institutional investors to integrate climate risk and an overview of environmental considerations into their public communications. Large institutional investors are defined as entities belonging to a group that prepares consolidated or combined financial statements with a balance sheet total of less than 500 million euros, as well as portfolio management companies with less than 500 million euros outstanding.

A crucial measure in achieving the greening of the economy through finance, Article 173 requires that the climate change risks associated with an entity's actions, as well as its contribution in achieving the objectives of the ecological transition be communicated. It distinguishes between physical risks, such as exposure to direct consequences induced by climate change, and transition risks, defined as exposure to changes induced by the transition to a low-carbon economy[4].

These non-financial reporting requirements apply to France's large institutional investors, of which insurance companies and asset managers make up the bulk[5]. Be that as it may, the "comply or explain" principle allows companies to justify the absence of their respective reporting requirements. For example, a clear and substantiated explanation of the reasons justifying the possible absence of non-financial reporting is, for the time being, an acceptable alternative. The French government's long-term objective is to make the disclosure of non-financial reporting mandatory, effectively putting an end to such justifications of absence.

[1] Directive 2014/95/EU of the European Parliament and of the Council (22 October 2014) amending Directive 2013/34/EU as regards the reporting of non-financial information and information relating to diversity by specific large companies and groups.

[2] European Commission (2020), "Consultation on the renewed sustainable finance strategy".

[3] Legifrance (2017), Loi n° 2015-992 du 17 août 2015 relative à la transition énergétique pour la croissance verte - Article 173.

[4] Legisfrance (2015), Décret n° 2015-1850 du 29 décembre 2015 résultant de l'article 173 relatif à la Transition Energétique pour la Croissance Verte.

[5] The scope of the law is much broader and covers insurance companies, mutual insurance companies, pension institutions, portfolio management companies, deposit boxes and consignments – among others.

B. Heterogeneity of informational disclosure: an obstacle to comparability

Today in 2020, after 3 annual publications, an evaluation of the application of Article 173 is possible. The Ministry in charge of ecological transition, together in partnership with the Ministry of Economy, the French Financial Market Authority (AMF) and the Prudential Supervision Authority[6] has published an assessment of the application of the provisions of the decree of 29 December 2015, specifying the obligations of Article 173.

The review concludes **that reporting practices are encouraging and reflect the growing interest of investors**, particularly from insurers and pension companies. It also highlights that Article 173 has enabled new players to become involved in this process. Among them, more and more consider that environmental, social and governance (ESG) criteria can be used to complement traditional methods of financial risk management and thereby become a strategic source of opportunities.

That said, **certain entities nevertheless fail to disclose ESG considerations in their investment selections**, rarely providing reasons to support their decision despite the law's "comply or explain" principle.

Finally, **the significant heterogeneity of reporting in terms of quality, level of detail, relevance and comparability is noteworthy**. This heterogeneity stems in part from a lack of maturity concerning the indicators and methodologies used in reporting (complex metrics, poor data availability, etc.), which currently lack reliability and consistency.

With regard to the insurance sector, the World Wildlife Foundation (WWF), a non-governmental organization, surveyed 17 French insurers in 2019 for the second time to assess the evolution of the application of the 2015 decree on the Energy Transition for Green Growth Act (LTECV) by the insurance industry. The survey concluded that compared to the previous year's exercise, the trajectory of insurers towards full compliance is encouraging. Asset coverage rates have improved, metrics are more diversified, and educational initiatives for an uninformed public are multiplying. Major advances mostly concern the "green activities" indicator, which is increasingly used despite the lack of a harmonized definition. In addition, more and more insurers are estimating the energy trajectory of the companies in their portfolios, comparing it to the trajectory set out in limiting the 2°C rise in temperature essential in limiting global warming.

[6] Autorité de Contrôle Prudentiel et de Régulation (ACPR).

02.

Indicators needed to address shortcomings

In an attempt to offer concrete turnkey solutions that improve the publication of non-financial information by major groups, **four insurers have developed indicators that contribute to greater clarity and comparability**[7]. It is partly due to the successful implementation of the recommendations of the international community's Taskforce on Climate-related Financial Disclosures (TCFD), created by the G20. Chaired by Mr. Bloomberg, UN Special Envoy for Climate Action and Mayor of New York City, alongside former Bank of England Governor Mark Carney, the initiative is itself driven by the finance industry[8]. In June 2017, the Commission issued recommendations for harmonizing climate-related disclosure in the financial sector. Its recommendations, which are currently voluntary, are increasingly taken up. In the span of one year – between 2017 and 2018 – the international standards proposed have become an indispensable reference for institutional investors and

[7] There four insurers being Allianz, AXA, Aviva and CNP.

[8] Task Force on Climate-related Financial Disclosures (2019), "2019 Status Report".

companies. Thus, 1,027 organizations representing over $12 trillion (compared to $ 7 trillion in 2018) have chosen to adhere to a common set of recommended standards in 2020[9]. In the long term, the TCFD's recommendations could become mandatory.

Based on the results published by the aforementioned leading insurers in the field, two indicators should be standardized and developed to better take into account environmental risks: **"thermometers" reflecting rising temperature scenarios, and the amount invested in** sustainable activities.

A. The double advantage of thermometers reflecting rising temperature scenarios

At the international level, several initiatives have been launched to align corporate strategies with an environmental objective. For instance, the Science Based Targets Initiative (SBTi) is an initiative to boost corporate ambition for climate action[10]. The initiative encourages the mobilization of companies in setting greenhouse gas emission reduction targets consistent with the level of decarbonation required by science to limit global warming to less than 1.5°C / 2°C[11]. The SBTi is currently developing sector-specific methodologies and is working on a framework to guide the financial sector. In particular, the thermometer is an indicator that illustrates the impact of a company's activities on climate change. It also enables companies to set a strategy for aligning their investment portfolios with a 2°C trajectory for limiting global warming.

Today, two insurers – Axa and Aviva – use a thermometer indicator. Indicated are scenarios wherein a rise in temperature reaches 3.1°C versus the market average of 3.7°C. Conversely, CNP Assurances and Allianz do not have thermometers but talk about reducing the carbon footprint in percentage terms (by sector or by employee). CNP Assurances indicates that in order to reduce the investment portfolio's exposure to transition risks, it has set key objectives of which reducing the carbon footprint of its listed equity portfolio by 47% between 2014-2021 and of its real estate portfolio by 40% between 2006-2021[12] is included. Likewise, Allianz's 2019 CSR report announced that it has reduced its carbon footprint per employee by 35% compared to 2010[13].

Although such figures exist, it is extremely difficult to compare them since carbon footprint reductions are evaluated over unrelated periods of time and using disparate methodologies (i.e. carbon footprint per sector vs. per employee). Contrariwise, **the thermometer indicator allows for a more comprehensive assessment of impact that lends itself to comparison**. Harmonization of data collection methods between companies is thus paramount, albeit requiring additional research on non-climate aspects such as biodiversity. On these issues, there is still room for improvement concerning the state of the research, as well as impact assessment.

B. Sum of investments in sustainable activities: a promising indicator that needs refining

A lack of comparability is reflected in the sum of investments in green and/or sustainable activities. Insurance companies use these two terms in alternating ways that carry different meanings.

For example, Allianz reported 29.4 billion euros worth of investments in sustainable development in 2019[14].

---

[9] Task Force on Climate-related Financial Disclosure, TCFD Supporters.

[10] The STBi is a joint initiative with the Carbon Disclosure Project (CDP), the United Nations Global Compact (UNGC), the World Resources Institute, and the WWF, launched in 2015.

[11] Compared to pre-industrial temperatures.

[12] CNP Assurances (2019), « Rapport de gestion du Conseil d'Administration, exercice 2019 ».

[13] Allianz (2019), « Travailler ensemble pour un avenir durable : raisonner sur le long terme », Sustainability report.

[14] *Ibid.*

In 2018, Aviva invested an additional 2.3 billion euros in energy transition[15] on top of the 7 billion euros in funds designated for Socially Responsible Investment (SRI) at the end of October 2019[16]. Delving further into the details, Aviva France stated that it had invested 103 million euros towards energy efficiency in the certified/labelled green real estate portfolio, 1.47 billion euros in green bonds, and 340 million euros in sustainable bonds. Furthermore, CNP pledged to reach 5 billion euros in new green investments for the energy and ecological transition between 2018-2021[17]. For the year 2019, AXA announced 12 billion euros in green investments[18].

These figures are complex to interpret and exhibit the general absence of sustainable investment harmonization. The strategy of alignment with the climate objectives of companies through these investment pledges is difficult for investors to evaluate and impossible to compare given that, as previously mentioned, the stated sums concern diverse investments (real estate, shares) relating to disparate periods of time (annual, multi-year). In addition, although allowing for the monitoring of data based on a strategy with defined objectives, year-to-year improvement trends do not appear in all non-financial statements. This is mainly due to the fact that Article 173 came into force in 2017, meaning companies have only come to publish their third report in 2019.

In any case, **the publication of company brown activities – *i.e.* the sum of a company's environmentally harmful assets – is non-existent for the four aforementioned insurers**. In their defense, even the recent European taxonomy of green assets does not request large groups to disclose brown business shares. Nevertheless, this may change upon revision of the regulation. As regards brown activity transparency, **French insurance companies MACIF and MACSF are pioneers in the field. Given its importance from the point of view of greenhouse gas emissions, it would be of interest to make the publication of companies' brown activities mandatory**.

[15] Aviva, « Notre stratégie Aviva Solutions Durables ».
[16] Aviva (2019), « Déclaration de Performance Extra-Financière Rapport Aviva Solutions Durables »
[17] CNP Assurances (2019), « Rapport de gestion du Conseil d'Administration, exercice 2019 ».
[18] AXA (2019), « Rapport financier annuel 2019 ».

03. The NFRD Directive: the European equivalent of France's Article 173

A. An integral part of the European Commission's Sustainable Finance Action Plan

At the European level, the European Commission has appointed a High-Level Expert Group (HLEG) to make recommendations on how to improve the EU's sustainable finance strategy. The group, composed of members and observers from the banking sector, insurance sector, stock exchanges, asset management, financial sector associations, international institutions and civil society, began its work in January 2017 and delivered its final report in January 2018.

The European Commission pursued the initial recommendations of the HLEG by adopting an ambitious action plan on sustainable finance on 8 March 201819. This action plan has 3 objectives: redirect capital flows towards sustainable investments in order to achieve sustainable and inclusive growth; manage the financial risks induced by climate change, resource depletion, environmental degradation and social issues; and promote a long-term vision and transparency in economic and financial activities[20].

[19] European Commission (2018), "Sustainable finance: Commission's Action Plan for a greener and cleaner economy".
[20] Autorité des Marchés Financiers (2019), « Point d'étape réglementaire européen : Avancée des travaux finance durable (Disclosure et Benchmark) ».

This plan has 10 key actions, the ninth of which is to improve sustainability disclosure and accounting rule-making. Like Article 173, the NFRD aims to improve the reporting of non-financial information, as well as information relating to diversity by select large companies and groups[21]. This directive has its roots in the Commission's communication entitled: "A Renewed EU strategy 2011-2014 for Corporate Social Responsibility (CSR)", adopted in 2011. The purpose of this communication was to encourage the reporting of social and environmental information by companies via the introduction of a legislative proposal, eventually leading to the NFRD directive that came into force in 2017.

Article 1 of the directive stipulates that "[l]arge undertakings which are public-interest entities exceeding on their balance sheet dates the criterion of the average number of 500 employees during the financial year shall **include in the management report a non-financial statement containing information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to, as a minimum, environmental… matters** […]".

To meet these transparency objectives, all information within the purview of the following categories must be reported:

a brief description of the undertaking's business model;

a description of the policies pursued by the undertaking in relation to those matters, including due diligence processes implemented;

the outcome of those policies;

the principal risks related to those matters linked to the undertaking's operations including, where relevant and proportionate, its business relationships, products or services

which are likely to cause adverse impacts in those areas, and how the undertaking manages those risks;

non-financial key performance indicators relevant to the particular business[22].

Once again, it is important to note that a company's non-financial declaration is waived upon presentation of a clear and reasoned justification of its absence, and where its absence is accepted. This is the principle of the "comply or explain" approach, as set out in the above-mentioned Article 173 of the French Energy Transition for Green Growth Act (LTECV).

B. The correlation between the NFRD and taxonomy

There is an important link between the NFRD directive and taxonomy, which is with the end goals of i) establishing a list of activities considered economically sustainable and ii) eventually contributing to the creation of green European standards and labels in defining financial products. The taxonomy references the Non-Financial Reporting Directive in order to allow for an alignment between the transparency requirements of companies (NFRD) and those of the financial actors covered by the taxonomy. This reference in the taxonomy regulation ought to enable financial players to obtain the information needed from companies in order to meet their own transparency requirements. Since the NFRD's entry into force, financial players have been able to base their investment decisions on detailed reports and thus contribute to the financing of a low-carbon economy.

Given the dual role of banks, another challenge concerning the directive's revision is their integration into the debate and the coinciding issues that may arise.

[21] Directive 2014/95/eu of the european parliament and of the council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

[22] *Ibid.*

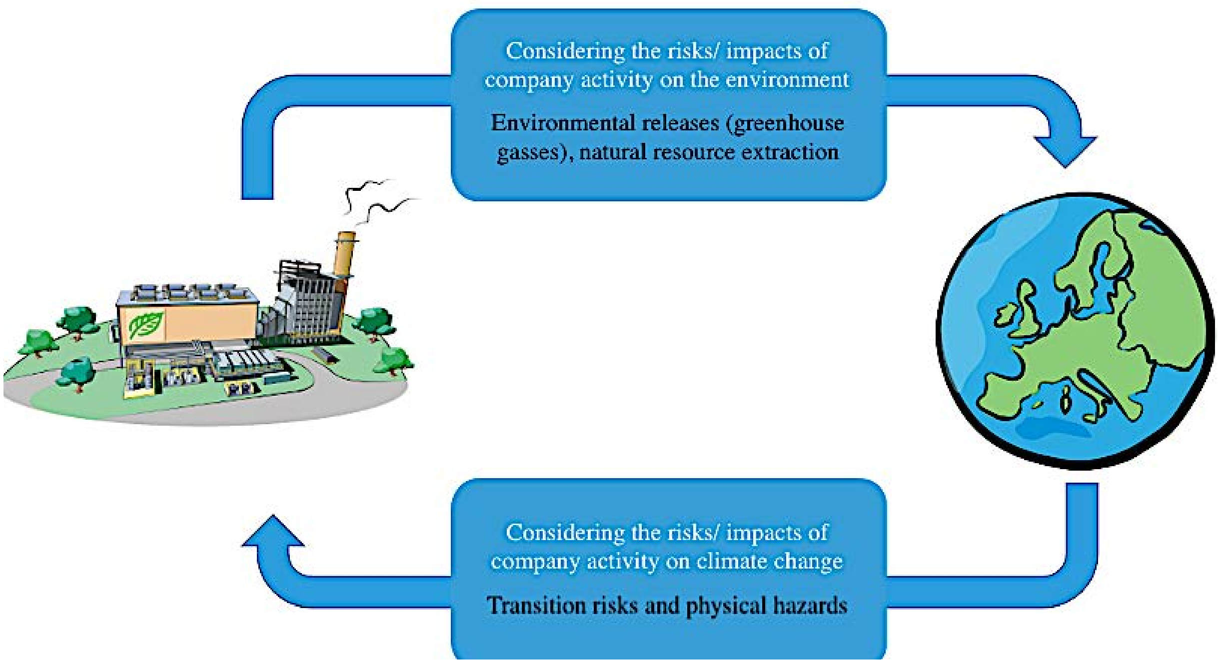
Banks are affected by the obligations to publish non-financial information as issuers of data, but also as users of data. It is this second dimension that creates obstacles in meeting the reporting expectations of the legislator.

C. Non-applicable non-financial reporting

Since the NFRD's entry into force (2017), difficulties concerning non-financial reporting have persisted, among them being an overall lack of comparability, reliability and relevance. To assess compliance with the directive, the Climate Disclosure Standards Board conducted a study on the non-financial reporting of Europe's 50 largest companies in 2019, thus covering the 2018 results[23]. The findings are similar to those observed at the French level: the quality, consistency and connectivity of non-financial information needs improvement in order to enhance its usefulness in decision making. Moreover, a coherent vision of the company's overall activities – i.e. its development, performance, position and impact on the environment – is impossible in the absence of linkages between the various categories of information required by the directive.

The results of the study thus reveal several major problems in the implementation of the directive, justifying its revision:

The double materiality of a company's CSR indicators



[23] Climate Disclosure Standards Board (2020), « Falling short? Why environmental and climate-related disclosures under the EU Non-Financial Reporting Directive must improve ».

- **Irrelevancy of information provided**: 1/ 3 of the reported non-financial information concerning due diligence does not address the role of management in the supervision of environmental policies. In addition, often absent is an evaluation of the company's governance instruments used in meeting its stated ambitions.
- **An overall lack of comparability concerning reported information**: report users' ability to compare the relative performance of companies is reduced due to significant variations in reported information.
- **The principle of double materiality is still little understood.** This principle consists of taking into account both the impacts of the company's activities on the environment, as well as risks related to climate change incurred by the company. The latter is often overlooked entirely. Although reporting the risks that their activities pose to the environment, many companies do not take into account the risks their business models may be exposed to in the longer term due to environmental degradation.

04. Recommendations and current debates

Based on funding beneficiaries' choices, funding has a significant role to play in order to truly green the economy. As such, the **NFRD directive is crucial to ensuring transparency, without which investors cannot make informed decisions. Correspondingly, the directive also effectively guides the choices of companies in search of market financing** towards more sustainable activities. Against the background of the ongoing Sustainable Finance Strategy review launched by the Commission for the purpose of improving the non-financial reporting of companies, we consider the following changes to be necessary:

1. **Make mandatory the reporting of non-financial information, ending the "comply or explain" approach**. With regard to its format, there is a debate on the appropriate placement of non-financial information: it can either be integrated into the main report or be presented in a supplemental report. In the latter case, there is a risk that the information will be treated separately to the rest of the report, whereas the aim remains the consolidation of financial information with non-financial information.
2. **Include the term 'climate' in the NFRD directive**, hitherto unmentioned in its contents. 'Climate' is often confused with 'the environment': by referring to all meteorological phenomena that characterize the average state of the atmosphere, it is clear that certain processes –i.e. the emission of greenhouse gases – have a definite impact on global warming while posing no direct threat to the environment. As such, it is important to take into account both the environment and the climate.
3. **Set up a database to centralize all ESG data at the European Union level** in order to facilitate access to this data for companies wishing to apply it, giving specific focus to listed small and medium-sized companies, which represent 80% of listed companies.
4. **Broaden the scope of the directive**. There is heavy debate on this issue. Some groups[24] are calling for the expansion of non-financial reporting requirements to include companies with more than 250 employees, compared to the current threshold of 500. With an expanded scope, financial institutions would be able to collect additional information essential in meeting their

[24] Notably the Climate Disclosure Standard Board.

own transparency obligations. This priority does not seem to be the most urgent of concerns raised, at least not in the short term. Good results for Europe's largest companies are paramount prior to asking for input from smaller companies, for whom the effort to report their information could pose significant costs. For listed SMEs, to whom investors are increasingly asking for ESG information, special support should be provided[25].

5. **Working towards the standardization of criteria for enhanced clarity**. The directive's revision should provide greater clarity and comparability for investors. Following this objective, and provided that the evaluation methods are specified, – i.e. corresponding to i) what timeframe, ii) which of the company's endeavors, etc. – thermometers and sums invested are indicators with strong potential. If left unstandardized, the **risk of "greenwashing" is ever more likely**. Consequently, claiming sustainability becomes a marketing method consistent with presenting ecological rhetoric to the public despite a lack of substantial environmental practices to match those ambitions. Nevertheless, according to think-tank I4CE, the call for standardized criteria should be addressed with caution26. According to the organization, standardization across scenarios could circumvent a company's exploratory phase wherein key issues are investigated, thus being counterproductive. As a major step forward in strategic thinking, this exploratory phase is indispensable in innovative areas such as soft mobility methods (which are increasingly appealing to consumers) and certain renewable energy technologies. When it comes to reporting on scenario analysis, standardization is certainly not a panacea; nonetheless, a narrower description of published information categories is called for.
6. **Take into account overlapping legislation at all levels.** There exists a risk of consistency problems between legislations. References include article 173 of France's Energy Transition for Green Growth Act (LTECV), Europe's NFRD directive, as well as the recommendations of the TCFD at the international level. The recommendations of the TCFD focus on governance, strategy, risk management and the system for measuring objectives. The risk of confusion for companies is real. In order to avoid it, it is recommended that legislators ask themselves the following two questions: where should the information be made available, and where could synergies be created as concerns information required by the directives and regulations? For investors to be able to support companies' virtuous CSR practices, information must remain visible. Moreover, **the obligation of disclosing information in the company's financial report should not be too burdensome**. The NFRD should stick as close as possible to the recommendations of the TFCD, which is the international reference already broadly used by European companies.

An example of a potential synergy would be for companies impacted by the NFRD to include the 6 environmental objectives of the taxonomy in their financial report:

1. climate change mitigation
2. climate change adaptation
3. sustainable use and protection of water and marine resources
4. transition to a circular economy
5. pollution prevention and control
6. protection and restoration of biodiversity and ecosystems

[25] Eurofi (2020), « ESG Report on Small & Mid-Caps ».
[26] I4CE (2020), « Non-Financial Reporting By compagnies and scenarios analysis: be cautious with standardization ».

The urgency for France, whose problems are even further related to the overlapping of multiple legislations on the publication of non-financial information, is to revise the decree implementing Article 173 to allow for alignment with the TCFD standard[27]. Vis-à-vis its influence in green finance, as well as its engagement at the EU level, France should also back an ambitious reform of the NFRD directive at the European level.

Conclusion

The revision of the EU's sustainable finance strategy aims to take as holistic a view as possible of financial regulation, thus fully reorienting capital flows towards transition while also steering clear from select "niche" approaches. To do so, it aims to strengthen sustainable investment by creating an enabling framework through appropriate tools and structures. The main objective is to integrate climate and environmental risks into the wider management of the financial system.

This revision will be keeping with the series of actions established by the European Commission following its 2018 action plan[28]. Among the most important measures include:

- The publishing of the regulation on the establishment of a framework to encourage sustainable investment, better known as the Taxonomy Regulation in the Official Journal of the European Union on June 22, 2020[29].
- The publishing of the regulation on the publication of information relating to sustainable investments and sustainability risks, titled "Disclosure" in December 2019, which will introduce obligations at the European level, provided for in Article 173 of France's Energy Transition for Green Growth Act (LTECV)[30]. Article 29 of the Energy and Climate Law is the result of this directive's transposition into French law[31].
- The development of an Ecolabel for financial products for retail investors, which is currently under negotiation. The vote on this label is scheduled for the end of 2020.
- The development of a European green bond standard that will stimulate this weak but expanding market by enabling the accreditation of external auditors by the European Securities and Markets Authority[32]. The European Commission's Technical Expert Group on Finance (TEG) delivered its report in 2019, meaning this voluntary standard could become part of European law as early as 2020[33].

[27] Baker McKenzie and Principles for Responsible Investment (2020), « Recommandations de la Task Force on Climaterelated Financial Disclosures - Etude des éléments pertinents à l'échelle locale France ».
[28] Deschryver, P, Gardes, C, Maret, T et Pèlegrin C. (2020), "Accelerating the Energy Transition: The Role of Green Finance and its Challenges for Europe", IFRI.
[29] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.
[30] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability‐related disclosures in the financial services sector.
[31] Légifrance (2019), LOI n° 2019-1147 du 8 novembre 2019 relative à l›énergie et au climat.
[32] Europe Jacques Delors (2020), « European Recovery Plan: Time for green and social bonds ».
[33] EU Technical Expert Group on Sustainable Finance, « Report on Green Bond EU Standard ».

Managing Editor
–
GENEVIÈVE PONS

Contact
–
Europe Jacques Delors
Penser l'Europe / Thinking Europe / Europa Denken
Rue du Duc 139, 1200, Bruxelles
+33 (0)1 44 58 97 97
www.delorsinstitute.eu
info@europejacquesdelors.eu