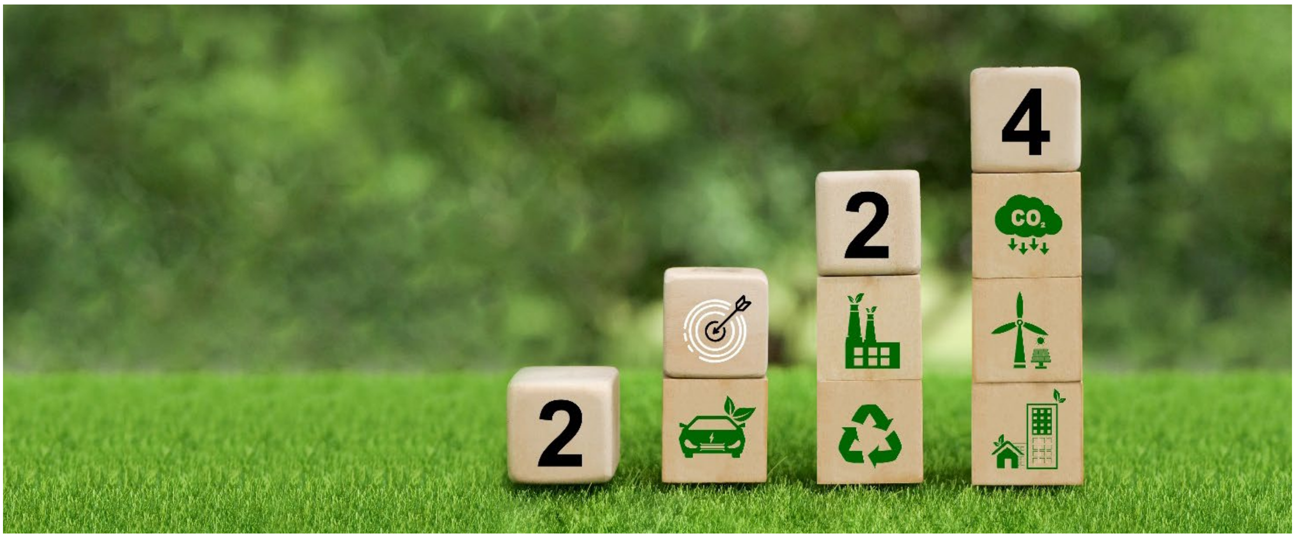
ESG regulation – an outlook on developments for the year 2024

OVERVIEW OF THE MOST IMPORTANT REGULATORY CHANGES THAT WILL SHAPE 2024



Executive Summary

- Implementation of changes to the non-financial reporting obligations by the member states as a result of the Corporate Sustainability Reporting Directive and the European Sustainability Reporting Standards as well as new thresholds.
- Revision of international reporting obligations by the International Financial Reporting Standards IFRS S1 and S2.
- Anticipated revision of the Sustainability Finance Disclosure Regulation (at Level 1 and Level 2).
- Tightening of the ESMA guidelines on ESG-related fund names and consequently changes to the administrative practice of BaFin and CSSF.
- Stricter EBA requirements due to technical implementation standards; mandatory taxonomy compliance rate reporting.
- Increased due diligence obligations in accordance with the Supply Chain Due Diligence Act and the Deforestation Regulation.
- Applicability of reporting obligations under the European Carbon Border Adjustment Mechanism.
- Increased control of compliance with ESG-rules by the Luxembourg Financial Supervisory Authority CSSF.

  → Certain developments require immediate adaptation, while others are still being finalised.

  → Early preparation is key in the ESG jungle.

1. Background

Ever since the EU Action Plan on Sustainable Finance[1] at the latest, sustainability has undoubtedly been the dominant topic in Europe in recent years, not just in the financial sector. However, it goes without saying that the "sustainability journey" is far from over – which makes it all the more important to stay up to date and recognise and prepare for future developments at an early stage. At the beginning of 2024, a number of key legal changes will come into force; further relevant measures are already foreseeable over the course of the year. All of these share a particular relevance for the "operational implementation" of ESG aspects in companies and must therefore be well planned ahead of time.

2. Sustainability reporting in accordance with the CSRD

The Corporate Sustainability Reporting Directive (CSRD)[2] ushers in a new era of sustainability reporting. The content of the reporting obligations is regulated separately by the European Sustainability Reporting Standards (ESRS), which were introduced at the same time as the CSRD.

The first European companies and groups have had to implement these requirements as of 1 January 2024. Initially, the new regulations will affect companies that were already required to submit non-financial reports. The group of companies affected will then be gradually expanded until 2028. In addition, standards for small and medium-sized capital market-oriented companies (SMEs) will be developed in the course of 2024 to support them in their sustainability reporting.

In this context, the European Securities and Markets Authority (ESMA) has also published a statement with enforcement priorities for annual reports relating to the 2023 financial year.[3] This specifically emphasises audit priorities for non-financial reporting, in particular with regard to the required taxonomy reporting (in accordance with Regulation (EU) 2020/852), reporting on climate-related targets, measures and progress and reporting on Scope 3 greenhouse gas emissions.

You can find an overview of the CSRD in our GSK Update on the CSRD.[4]

Furthermore, the EU Commission recently published two delegated acts: firstly, Delegated Regulation (EU) 2023/2772, which contains the European Sustainability Reporting Standards (ESRS) in its annexes, which specify the sustainability reporting obligations under the CSRD[5]; and secondly, Delegated Directive (EU) 2023/2775, which adjusts the thresholds for the size categories of companies in line with inflation.

The latter still needs to be transposed into national law in order to become effective. The EU member states have to comply with this by 24 December 2024 at the latest. The national implementation of this amendment is of

[1] See also our GSK Update: EU Action Plan on Sustainable Finance – New Sustainability-related Disclosures in the Financial Services Sector.
[2] Directive (EU) 2022/2464 on sustainability reporting by companies: Publications Office (europa.eu).
[3] ESMA Public Statement: ESMA32-193237008-1793 2023 ECEP Statement (europa.eu)
[4] GSK Update: Neue Vorgaben zur Nachhaltigkeitsberichterstattung – die CSRD im Überblick (gsk.de).
[5] Further information on the ESRS can be found in our GSK Update : Konkretisierung der CSRD durch umfangreiche neue Reportingstandards (gsk.de).

considerable importance for German companies, as it will determine, among other things, the date from which corresponding (non-)financial reporting is required.

Company category	New threshold total balance sheet	New threshold net sales
Micro-enterprises	< € 450,000 €	< € 900,000
Small companies*	< € 5,000,000 €	< € 10,000,000
Medium-sized companies	< € 25,000,000	< € 50,000,000
Large companies	> € 25,000,000	> € 50,000,000

*Member states may set higher thresholds up to a maximum of €7,500,000 for the total balance sheet and €15,000,000 for net sales.

In terms of timing, a distinction must be made with regard to the size of the company. For large companies that are already obliged to report on sustainability under the Non-Financial Reporting Directive (Directive 2013/34/EU), or **NFRD/Balance Sheet Directive**, the reporting obligation applies to financial years beginning on or after 1 January 2024. For financial years beginning on or after 1 January 2025, large companies with either a balance sheet total of more than EUR 20 million, sales revenue of more than EUR 40 million or more than 250 employees also fall under the reporting obligation, if they meet at least two of these three criteria. Finally, the reporting obligation will also apply to listed small and medium-sized enterprises (SMEs) from 2026 onwards. Additional regulations include provisions on the application to group structures.

3. Sustainability reporting outside the EU

New sustainability reporting standards have also been in force outside the EU since 2024. In November 2021, the International Accounting Standards Board (IASB) established a body specialising in sustainability reporting. The International Sustainability Standards Board (ISSB) is intended to flesh out the requirements for reporting environmental issues. In addition to IFRS S1 and IFRS S2, which are already published, further guidelines are in the works. Similar to the ESRS, the IFRS standards provide a basis for globally standardised sustainability reporting. These standards have also been applicable since 1 January 2024 and are particularly relevant for companies that operate internationally or have investors from countries outside the EU.

4. Revision of the EU Disclosure Regulation

Last September, the EU Commission launched a consultation on the review of the Sustainability Finance Disclosure Regulation (Regulation (EU) 2019/2088, also known as **SFDR**),[6] which ended 22 December 2023.[7] It is being discussed that there could be some extensive changes compared to the previous version – which has been in force since March 2021. For example, the disclosure obligations at company level in the SFDR could be removed and replaced by the obligations of the CSRD (see above). In addition, the current disclosure logic for strict classification as so-called “Art. 6 products”, “Art. 8 products” or “Art. 9 products” could be dropped. Shortcomings in this classification have become apparent in the past, for example from the “Art. 8-Plus” classification created by the market for MiFID marketing. Instead, the European Commission is now considering introducing sustainability disclosure standards for all financial products. On the other hand, it is considering switching to a more differentiated classification system for sustainable products.

[6] See also our article: [Neue Offenlegungsverordnung zu Nachhaltigkeit greift ab 10. März (gsk.de)](gsk.de).
[7] EU Commission: Targeted consultation on the implementation of the SFDR.

On 4 December 2023, the European Supervisory Authorities (ESAs) also published their final report on the amendment to the Delegated Regulation on the SFDR (RTS) and submitted it to the European Commission.[8] This final report builds on the ESA's consultation draft from April of last year, taking into account the comments received. The proposed amendments relate in particular to the Principal Adverse Impacts (PAI) and the adaptation of the templates for Art. 8 and Art. 9 products attached as annexes.

The European Commission now has three months to review the revised RTS. If the ESAs draft is adopted without changes, the amendments will enter into force on the 20th day after publication in the Official Journal of the EU. This means that the present amendments could be applicable for the PAI statement to be published by financial market participants as early as on 30 June 2024.

Practical note
Financial market participants should check at an early stage whether they have the necessary data to fulfil the reporting obligations in accordance with the updated SFDR templates or whether their processes still need to be adapted for this purpose.
With the entry into force of the new RTS, all ESG annexes for financial products in accordance with Art. 8 and Art. 9 SFDR will be amended in the short term. This should be taken into account for capacity and cost planning for 2024.

5. ESMA guidelines on ESG terms in fund names

At the end of 2023, the European Securities and Markets Authority (ESMA) published a revised version of its guidelines on the use of ESG or sustainability-related terms in fund names.[9] Accordingly, the use of ESG or sustainability-related terms in fund names is subject to certain conditions: Such terms may be used if ESG criteria or sustainability objectives are taken into account for at least 80% of the investments. In addition, it is assumed that the exclusion criteria of the Paris-aligned Benchmarks (PAB) are taken into account and that a significant proportion is invested in sustainable investments within the meaning of Art. 2 para. 17 SFDR in order to reflect the expectations of investors based on the fund name. In addition, the guidelines also address transition-related terms and the case of a combination of terms for the first time.

The guidelines are expected to be finalised in the second quarter of 2024 and will then apply to new funds three months after their final publication. Existing funds will have a transitional period of another six months to comply with the new requirements. From this point onwards, affected financial products must either comply with the required investment ratios or the fund name must be changed.

Practical note
It is expected that the ESMA guidelines will replace BaFin's current administrative practice based on the draft BaFin guideline for sustainable investment funds dated August 2021.

For all new, longer-term funds that are to be launched now, it is advisable to follow the upcoming ESMA guidelines in order to avoid having to make adjustments when the new regulations come into force.

Existing funds should also look into this, as they may also be affected by the guidelines after a transitional period of six months.

[8] Final Report on draft Regulatory Technical Standards on the review of PAI and financial product disclosures in the SFDR Delegated Regulation.

[9] ESMA Public Statement: Update on the guidelines on funds' names using ESG or sustainability-related terms.

Funds that are subject to supervision by the Luxembourg Financial Supervisory Authority *Commission de Surveillance du Secteur Financier* (**CSSF**), regardless of whether they qualify as an Article 6, 8 or 9 product, must use fund denominations that are consistent with the respective investment objective and investment policy of the fund and with the ESMA Guidelines[10]. The CSSF also expects that future developments on this topic will also be implemented at the European level.

6. EU Taxonomy Regulation

Since 1 January 2023, non-financial companies have had to provide evidence of the rate of conformity of their business activities with the environmental objectives of the Taxonomy Regulation (Regulation (EU) 2020/852)[11] as part of their reporting.[12] However, this only applies to the environmental objectives of *climate protection* and *adaptation to climate change*. From 1 January 2024, the reporting obligation will also apply to financial companies when it comes to these two environmental objectives. With regard to the other environmental objectives[13], however, non-financial companies fall under the reporting requirement as of 1 January 2025 and financial companies as of 1 January 2026 [14].

At the end of 2023, the European Commission also published two documents with frequently asked questions (FAQs)[15] on the aforementioned matter. The first FAQ document dated 20 October 2023[16] focuses on topics relating to the technical assessment criteria for the two climate-related environmental targets. The second document – also dated 20 October 2023 -⁻ focuses on topics relating to taxonomy reporting. It contains a total of 34 questions and answers on the general application of the Taxonomy Regulation.

The explanations are aimed in particular at financial companies that have to report under the Taxonomy Regulation. "*With this notification, the Commission aims to facilitate compliance with the legal requirements in a cost-effective manner and to ensure the usability and comparability of the reported information for the expansion of sustainable finance,"* writes the EU Commission. The implementation of the EU Taxonomy is to be facilitated by a communication on the legal interpretation and implementation of the technical screening criteria.

7. Regulation of the value chain

ESG regulations are increasingly being extended to the entire value chain of companies. In addition to CSRD reporting obligations along the value chain, more due diligence obligations apply: The Supply Chain Due Diligence Act (*Lieferkettensorgfaltspflichtengesetz*, LkSG) has been applicable to companies with more than 1,000 employees and a registered office in Germany since 1 January 2024. Credit institutions and insurance companies are not subject to any due diligence obligations in relation to their customers, but are certainly subject to due diligence obligations in relation to their suppliers of goods, services, etc.

[10] See point 3.2.1 in the *CSSF Thematic Review on the implementation of sustainability-related provisions in the investment fund industry*.
[11] See also our GSK Update: Taxonomie-VO – Strengere Anforderungen an Nachhaltigkeit von Immobilien (gsk.de).
[12] Art. 10 of the Del. Regulation (EU) 2021/2178.
[13] (3) Sustainable use and protection of water and marine resources, (4) Transition to a circular economy, (5) Prevention and reduction of pollution, (6) Protection and restoration of biodiversity and ecosystems.
[14] See Art. 5 of the Del. Regulation (EU) 2023/2486.
[15] Announcement of the Commission (FAQ on the Taxonomy Regulation).
[16] FAQ of the EU Commission (C/2023/267).

A different stipulation was made in the provisional agreement in the European trilogue negotiations on the Corporate Sustainability Due Diligence Directive (CSDDD)[17] – financial companies are to be completely excluded from the scope of application for the time being. However, if the CSDDD is adopted, this decision will be reviewed in the future.

At the end of the year, the requirements of the EU regulation on deforestation-free supply chains *(*EU Deforestation Regulation, EUDR)[18] will also come into force. The requirements extend far beyond the handling of wood to a wide variety of raw materials and contain strict regulations (including a ban) on how certain relevant raw materials and products should be handled.

Practical note
In future, certain raw materials and products may only be imported, exported or made available in the EU market if they are not associated with deforestation and forest degradation. With regard to products made from raw materials such as cattle, cocoa, coffee, oil palm, rubber, soya and wood, this could mean far-reaching restrictions on previous business models.

8. ESG risks

Last year's additions to MaRisk (BaFin Circular 05/2023 (BA) – Mindestanforderungen an das Risikomanagement) in particular have once again brought the handling of ESG risks clearly into the regulatory focus and legal canon of risk management in the financial sector.

At the European level, this is now being expanded through an amendment to the Capital Requirements Directive (CRD; Directive 2013/36/EU), which is being supplemented by a new Article 87a regarding the handling of ESG risks. Within this framework, the European Banking Authority (EBA) is also required to develop guidelines for dealing with ESG risks.

The EBA responded to this request at the beginning of the year with a consultation draft.[19] It sets out requirements for internal processes and ESG risk management agreements that institutions should implement. It is recommended that institutions integrate potential ESG risks into their regular risk management. To this end, the EBA emphasises the need for a robust approach to managing and mitigating these risks over various time periods, including a 10-year horizon.

Risk management tools and cooperation with contractual partners should be utilised for this purpose. Integrating ESG risks into regular processes, internal controls and reporting structures, for example, ensure forward-looking ESG risk analyses and a risk-based perspective.

The three-month consultation on the EBA's preliminary guidelines will run until mid-April 2024. The feedback from the consultation will then be incorporated into the final version, which is due to come into force by the end of 2024 (depending on the date of application of the new version of the CRD).

9. New key figures

According to the EBA's final draft for technical implementation standards (ITS) for Pillar 3 regarding regulatory disclosures on ESG risks in accordance with Article 449a of the Capital Requirements Regulation (CRR)[20], the Green Asset Ratio (GAR) must be reported since January 2024 – and including for data from the end of 2023. The EBA has adapted the content and timing of the GAR disclosure to the Delegated Regulation on Article 8 of the Taxonomy Regulation.

[17] See also our GSK Shortnews CSDDD – vorläufige Einigung erzielt (gsk.de) and our GSK Update Brüsseler Spitzen für das Weihnachtsfest: Finaler Vorschlag zum EU „Lieferkettengesetz" liegt vor (gsk.de).
[18] Regulation (EU) 2023/1115 on deforestation-free supply chains.
[19] Consultation paper on draft Guidelines on ESG risks management.pdf (europa.eu).
[20] EBA draft ITS on Pillar 3 disclosures on ESG risks.pdf (europa.eu).

The numerator of the GAR only includes receivables from companies that will in future be obliged under the CSRD to submit a non-financial declaration to provide information on the proportion of their sustainable economic activities. This means that in future, receivables from companies that are not subject to the CSRD will be counted as 0% for the purposes of the GAR in accordance with the EU Taxonomy.

The EBA is also introducing a new indicator, the Banking Book Taxonomy Alignment Ratio (BTAR). The BTAR was created in view of the fact that the GAR alone does not provide a complete picture of a bank's sustainability activities and is to be disclosed alongside the GAR in Pillar 3 reports from June 2024.

Practical note
Banks should familiarise themselves now with the details of how BTAR is calculated. BTAR allows banks to communicate their sustainability activities more comprehensively, as far more requirements need to be taken into account than when calculating GAR. However, this goes hand in hand with additional reporting obligations and further challenges in obtaining the relevant data.

10. European CO_2 border adjustment mechanism

The European Carbon Border Adjustment Mechanism (CBAM) aims to create a financial compensation mechanism for the import of certain goods from countries that implement little or no climate protection measures. CBAM is part of the "Fit for 55 in 2030" package, the European Union's plan to reduce greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels, in line with the European Climate Law.

The first reporting obligations for importers began in October 2023 and by the end of January 2024 they will for the first time have to submit reports on the greenhouse gas emissions associated with their business relationships. These emissions are to be priced in future.

11. ESG focus of the CSSF in Luxembourg

The CSSF's priorities with regard to ESG for 2024 are essentially focussed on (i) the integration of sustainability risks by investment fund managers (alternative investment fund managers (AIFMs), management companies and external portfolio managers), (ii) compliance with existing ESG-related requirements and (iii) consistency of pre-contractual information in offering documents and on websites or as marketing material.

With regard to the consideration of sustainability risks, the CSSF emphasises that the delegation of portfolio management functions in particular has no influence on the investment fund manager obligations to disclose the consideration of sustainability risks. Accordingly, this also includes the obligation to implement an adequate risk management framework.

The CSSF will increasingly focus on verifying compliance, in particular with the ongoing disclosure obligations under Art. 11 SFDR in connection with Art. 50 and 58 of the SFDR RTS.

Particular attention is also paid to the increased control of the consistency of ESG-related disclosures made in pre-contractual documents (in particular offering documents with SFDR RTS annexes), websites and marketing materials.

12. Conclusion and outlook

It can be stated that the applicable sustainability-related laws and regulations in the financial sector will be further condensed and more detailed from 2024 on and will also be comprehensively reformed in some cases. While the concretisation process is still in full swing in some areas, the first fundamental revisions are already pending in others, to which financial market participants will have to react quickly and immediately.

Companies should immediately develop an implementation plan for the CSRD and examine the ESRS closely in order to fulfil the new standards for sustainability reporting. This includes the identification of relevant data sources and processes, which is why it may make sense to involve external consultants in some cases.

In addition, the new disclosure requirements under the SFDR need to be reviewed in a timely manner, particularly with regard to the fundamentally revised ESG annexes. Furthermore, if terms relating to "sustainability", "ESG" or similar are used in fund names, increased caution is required. As it is foreseeable that new regulations will come into force in the course of the year, it is worth focussing on these new requirements at an early stage in order to avoid being forced to act in the short term. The same applies to the requirements of the Taxonomy Regulation because it must be ensured that the newly required key figures can be integrated.

The ESG influence at various levels is likely to have become more noticeable in individual situations. It is also obvious that further national, European and international requirements will follow. In this respect, affected market participants must more than ever ensure compliance through appropriate planning and keep an eye on further regulatory developments.

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