Delivering 2030: Investor expectations of EU sustainable finance

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IIGCC

Foreword

Stephanie Pfeifer
CEO, IIGCC

This report is the culmination of our engagement and advocacy on a broad range of EU regulations, setting out the views of our investor members on the policy barriers to, and opportunities for, net zero alignment across the EU's sustainable finance landscape. We hope it can serve as a valuable contribution to the debate as the EU institutions build out their priorities for the next mandate to deliver on their 2030 climate goals and beyond.

Sustainable finance regulation in the EU is at an important crossroads. In 2018, the EU's High-Level Expert Group published its landmark report, which threw into stark relief the scale of investment needed to support the EU's climate goals. The report made clear that achieving this was beyond the capacity of public finance alone and set out a vision for a comprehensive and ambitious sustainable finance agenda to accelerate private investment in the transition.

Six years later, the Commission has translated many of that report's key recommendations into reality. The pace and intensity of the legislative agenda has been unprecedented, and the result is that the building blocks of a regulatory framework for sustainable finance are now in place. Investors now have access to the tools they need to identify climate solutions, assess the credibility of corporate transition plans, and manage their exposures to, and impact on, climate change. And the EU has established a regulatory framework for sustainable finance that provides a blueprint for other jurisdictions to follow.

What happens in the next six years is just as important. The incoming EU mandate will span the period running up to the critical milestone of 2030, and the Commission's focus must now turn from ambition to implementation. We have long advocated for the role policy must play in creating an enabling environment for scaling financial flows in line with climate goals and decarbonising the real economy. This is an opportune moment to build on the significant progress made and to ensure that the EU's suite of regulations provide a basis for channelling capital in line with net zero.

Reflections from the co-chairs

Jiska Klein
Senior Sustainability Manager, Asper Investment Management and Co-chair of IIGCC's EU Sustainable Finance Working Group

The EU has pledged to become the world's first climate-neutral continent by 2050 and has solidified its position as a pioneering force in sustainable finance through its framework. Both investors and corporations are increasingly realising the advantages stemming from the improved transparency regarding ESG risks, opportunities, and value creation that the framework has fostered. However, now is not the time for complacency or to lose momentum – there is still progress to be made to achieve these objectives. A unified effort is imperative to tackle short-term usability challenges, integrate the transition across the framework, and bridge the gap between sustainable finance and real economy policy. This report sets out a vision for resolving these issues and advancing towards the objectives of the European Green Deal.

Thibaud Clisson
Climate Lead, BNP Paribas Asset Management and Co-chair of IIGCC's EU Sustainable Finance Working Group

The next mandate will be decisive for determining whether the EU keeps on track to hit its 2030 targets. We have come far, and investors and the companies they hold have been equipped with many of the tools they need to support the transition. Now we need to double down on implementation and make sure the financial system is positioned to facilitate the decarbonisation of the real economy. This paper provides some valuable insights into possible ways forward, and how the Commission can build on its successes to date and keep up momentum in the second half of this critical decade.

Contents

1 Introduction

In this paper, prepared by the Institutional Investors Group on Climate Change ('IIGCC', 'we'), we assess the rapidly evolving landscape for sustainable finance in the EU. The paper explores policy-related barriers to, and opportunities for, channelling private capital in line with the transition to net zero ahead of the 2024-2029 EU mandate. The recommendations build on in-depth discussions with our members and existing IIGCC policy positions. They are also consistent with wider resources designed to support investors with their portfolio alignment activities, particularly the Net Zero Investment Framework (NZIF).[1] Each section of the paper can be read on a standalone basis, with our key recommendations set out in chapter 2, overarching views on the EU sustainable finance framework in chapter 5, and file-specific recommendations in chapter 6 (a full list of recommendations is included in the appendix).

IIGCC would like to thank the members of the EU sustainable finance working group who contributed to the content of this publication. If you are interested in learning more about our Policy work, please contact Leo Donnachie.

Scope of the paper

The intended audience of the paper is two-fold. By setting out investors' views on how the existing regulatory framework could be enhanced, and implementation challenges addressed, the paper provides useful insights to policymakers across the EU institutions as they build out their priorities for the next mandate. The paper seeks to provide a fair assessment of the achievements of the EU's existing sustainable finance regulatory framework, and the importance of high-quality regulation to support the net zero transition, while also acknowledging where further progress could be made.

The paper's secondary audience is institutional investors seeking to engage with policymakers to advocate for enabling policies that increase their ability to implement effective net zero investment strategies. The recommendations in this paper can be used to inform investors' advocacy in line with their individual net zero commitments and use of NZIF, which identifies policy engagement as a key lever for driving net zero portfolio alignment. The paper also includes several case studies highlighting how our members have previously engaged with policymakers on EU sustainable finance issues.

The EU's sustainable finance regime captures a broad range of financial market participants (FMPs) and real economy corporates. Many of the challenges and recommendations covered here will be relevant to a broader audience, including banks and insurers. However, the central focus of the paper is how the EU's sustainable finance framework can best support institutional investors, and the corporates they invest in, with their efforts to align with net zero. We also note that sustainable finance regulation covers a broad spectrum of sustainability issues beyond climate change. The topical scope of this paper is limited to climate change, and more specifically climate change mitigation. We acknowledge that mitigation forms only one part of an investor's response to climate change, and as temperatures increase, it is becoming increasingly important to address physical climate risks and invest in the necessary solutions to adapt to these risks. These issues, and the extent to which they are adequately accounted for in existing EU regulation, merits further work, and IIGCC will seek to engage on these topics in greater depth in the coming months.

While this paper focuses primarily on sustainable finance policy tools, it also recognises that the primary objective of these tools is to support the decarbonisation of the real economy. Chapter 7 explores the interactions between sustainable finance and real economy policy in the EU, and the need to establish 'feedback loops' between the two to create the right incentives and price signals to crowd-in private finance at pace and scale towards key sectors.

2 Key recommendations

Number	Regulation	Theme	Recommendation
1.	Taxonomy	Usability / data	Commit to a Commission review of the usability of Substantial Contribution and Do No Significant Harm criteria to address implementation issues, in line with the recommendations of the PSF's 2022 data and usability report
2.	Taxonomy	Reorienting capital	Ensure subsequent reviews of the Taxonomy increase the range of Taxonomy-eligible activities in line with the PSF's list of priority economic activities and wider high impact activities
3.	Taxonomy	Mitigating greenwashing risk	Uphold the scientific integrity of the Taxonomy by ensuring activities that are not compatible with a 1.5c pathway are removed from the 'transitional' category
4.	CSRD	Usability/data; mitigating greenwashing risk; reorienting capital	Commit to mandating disclosure of key climate-related indicators under the European Sustainability Reporting Standards (ESRS), irrespective of materiality assessments, including Scope 1, 2, and 3 GHG emissions and disclosures enabling investors to assess the credibility of corporate transition plans.
5.	CSRD	Usability/data; mitigating greenwashing risk; reorienting capital	Ensure sector-specific standards for the high impact sectors identified by EFRAG (including Capital Markets) are ready for adoption by mid-2026.
6.	CSDDD	Usability/data	Ensure detailed requirements for the implementation of transition plans align with sector-neutral and sector-specific ESRS.
7.	CSDDD	Reorienting capital	Commit to extending sustainability due diligence requirements under CSDDD to financial institutions in a proportionate and workable manner in the Commission's forthcoming review report.
8.	SFDR / EU Taxonomy	Mitigating greenwashing risk; reorienting capital	Clarify the framework to assess transitioning assets, leveraging the definition of 'sustainable investments' under SFDR or the EU Taxonomy to accelerate transition finance flows.
9.	SFDR	Mitigating greenwashing risk; reorienting capital	Deliver on proposals to introduce product categories/labels under SFDR, including a dedicated category for transition-focused investment strategies.
10.	SRD II	Usability/data; reorienting capital	Commit to reviewing SRD II under the next mandate and embedding the concept of sustainability more explicitly within the requirements, including the adoption of a revised definition of stewardship and potentially an EU Stewardship Code.
11.	Low Carbon Benchmarks Regulation	Usability/data; reorienting capital	Commit to reviewing the Low Carbon Benchmarks Regulation, adapting prescriptive methodological requirements to better support real-world decarbonisation and prioritising comprehensive and transparent disclosures.
12.	Fit for 55 package	Reorienting capital	Member States should swiftly implement the policies established under Fit for 55, to create price signals and commercial incentives that attract the necessary private investment in the real economy.
13.	Sector roadmaps	Reorienting capital	Develop sector roadmaps to increase transparency over how key sectors of the economy will decarbonise and by when, accompanied by targeted measures to crowd in private finance.

3 Executive summary

The European Commission ('the Commission') has stated that over 700 billion EUR in additional investment will be needed every year between 2021 – 2030[2] to ensure the EU is on track to become the world's first climate-neutral continent by 2050. The majority of this investment will need to come from private finance, and positively, a growing number of investors are making individual commitments at fund and portfolio level to align with net zero.[3] But for finance to flow at the scale and pace needed, supportive policy frameworks are essential. This includes sustainable finance policies that:

- Facilitate access to the robust, comparable data investors need to assess the credibility of investees' transition efforts and inform investment decisions and engagement activities;
- Mitigate greenwashing risk by establishing clear definitions and parameters for climate solutions and transition finance; and
- Encourage the reorientation of capital in a way that supports the decarbonisation of the real economy.

Following the launch of the Sustainable Finance Action Plan in 2018,[4] the key components of a comprehensive regulatory regime to help achieve these objectives are in place, and the EU has cemented its status as a world leader in sustainable finance. Nevertheless, investors and wider market participants have been grappling with regulatory implementation challenges. These implementation issues are in turn creating further barriers to scaling transition finance; barriers that must be addressed as an urgent priority in the next mandate if the EU is to close the net zero financing gap and keep on course to meet its 2030 targets.

The "regulatory wave" of the 2019-2024 mandate may be over, but now is the time for policymakers to reflect on the extent to which sustainable finance regulation is working in practice and achieving its aims. Critically, this does not necessitate new regulation as the key tools and levers that investors need to channel capital in line with net zero already exist. Instead, the focus must be on targeted enhancements or revisions to existing regulations that address the usability and implementation issues that investors and corporates have struggled with in recent years.

As part of this review of the existing regulatory landscape, the Commission should also ensure that existing regulation helps to identify and facilitate investment in entities operating in high emission and hard-to-abate sectors, whose transition is both necessary and will have the greatest impact on real economy emissions reductions. The concept of transition finance, and the role of regulation in facilitating it, is gaining traction amongst policymakers. But a lack of clarity around whether transitioning assets can be considered sustainable, alongside gaps in the EU's regulatory disclosure architecture, are hindering investors' capacity to direct capital towards the transition. A more explicit recognition of the need to finance these assets must be embedded within EU sustainable finance regulation, including through dedicated categories for financial products, and supported by comprehensive and widely available disclosures and criteria that enable investors to accurately assess the credibility of transition efforts.

The increased disclosure and transparency created by sustainable finance regulation is an important prerequisite for action - but is ultimately a means to an end. The next mandate must also focus on building out the links between sectoral and sustainable finance policy tools. Investors will only be able to provide the finance required to support the transition if the right incentives and sectoral policies are in place to drive the decarbonisation of high-impact sectors and the economy as a whole. If this happens, huge strides will be made towards unlocking private capital and delivering on the Commission's ambition to reduce emissions by at least 55% by 2030.

4 Policy advocacy and interaction with investors' net zero commitments

In recent years, a substantial number of investors have committed to aligning their individual portfolios and investment activities with the goals of the Paris Agreement. This has in part been driven by the growing recognition by investors of the need to manage financial risks and maximise the opportunities associated with climate change, in line with their fiduciary duties to clients and beneficiaries.

"Ensure any direct and collective policy advocacy we undertake supports policy and regulation relevant for achieving global net zero emissions by 2050 or sooner."

PAAO and NZAM commitment statements

Two of the main initiatives supporting investors seeking to align their investments with net zero are the Paris Aligned Asset Owners (PAAO)[5] and the Net Zero Asset Managers (NZAM) initiatives, which IIGCC helped to launch and co-convenes.[6]

Signatories to the PAAO and NZAM voluntarily commit to a range of actions to advance progress against their individual net zero objectives, including ensuring that any policy advocacy they undertake is consistent with the goals of the Paris Agreement. Signatories recognise that policy advocacy is an essential component of a comprehensive net zero strategy. Over 90% of asset owners that submitted responses to the PAAO 2023 progress report[7] stated they had undertaken some form of policy advocacy relevant for achieving net zero by 2050 or sooner, with the majority choosing to engage with policymakers collectively, especially through organisations like our own. Policy can act either as a systemic barrier or a key enabling lever to deliver on net zero targets. Indeed, the PAAO and NZAM commitment statements explicitly state that the achievement of investors' net zero targets are based on the expectation that governments will follow through on their own commitments to ensure the objectives of the Paris Agreement are met.[8]

Snapshot – Net Zero Asset Managers Initiative

- Over 315 signatories representing $57 trillion in AUM
- More than a third of signatories are headquartered in the EU
- Over half of NZAM signatories that have set individual net zero targets have selected NZIF as the primary methodology for net zero alignment (c. 60% use NZIF in combination with other methodologies)

Snapshot – Paris Aligned Asset Owners Initiative

- 56 asset owners representing $3.3 trillion in AUM
- Over a third of signatories are headquartered in the EU
- All signatories draw on NZIF to align their holdings with net zero

To deliver on their individual net zero commitments, PAAO and NZAM signatories use methodologies to set targets and align their portfolios. NZIF is the most implemented net zero methodology for investors and across all financial institutions within the Glasgow Financial Alliance for Net Zero (GFANZ). The primary objectives of the Framework are to enable investors to decarbonise investment portfolios and increase investment in climate solutions, in a way that is consistent with achieving global net zero emissions by 2050 or sooner and maximises decarbonisation of the real economy.

NZIF strongly encourages investors to engage with policymakers and regulators to address policy-related barriers, and capture opportunities for investing in climate solutions and transitioning portfolios consistent with net zero by 2050. It sets out a range of recommended actions and activities that investors may choose to undertake to support the overarching goal of aligning direct and indirect policy advocacy efforts with net zero, some of which are highlighted overleaf.

The policy advocacy component of NZIF 1.0 sets out a list of recommended topics which investors can engage with policymakers and regulators on. While a number of these recommendations remain relevant, the EU's sustainable finance agenda has evolved considerably since NZIF was launched 2021. This paper aims to build on its existing policy-related recommended actions, while suggesting new recommendations that investors can consider when undertaking direct and collective engagement on EU sustainable finance policy issues (see appendix for the detailed list). These recommendations are underpinned by IIGCC's collective advocacy on these issues and inputs from members of IIGCC's EU Sustainable Finance Working Group. The paper also includes examples of how IIGCC members have engaged with EU policymakers on specific sustainable finance issues.

NZIF 2.0, which will be launched in summer 2024, will build on the actions established under NZIF 1.0 with a comprehensive range of recommendations for policy advocacy and engagement. Investors can use this paper in conjunction with NZIF 2.0 to supplement the recommended, overarching actions on policy advocacy in the Framework with EU-specific actions.

Modes of investor engagement and advocacy
Direct engagement with policymakers and/or regulators
Writing position papers on specific policy areas
Publishing research supporting policy actions
Joining government-led technical advisory groups
Signing investor letters to policymakers
Media and public outreach
Responding to policy consultations

Source: PAAO Progress Report (November 2022)

5 Objectives of EU sustainable finance policy and state of play

Objectives

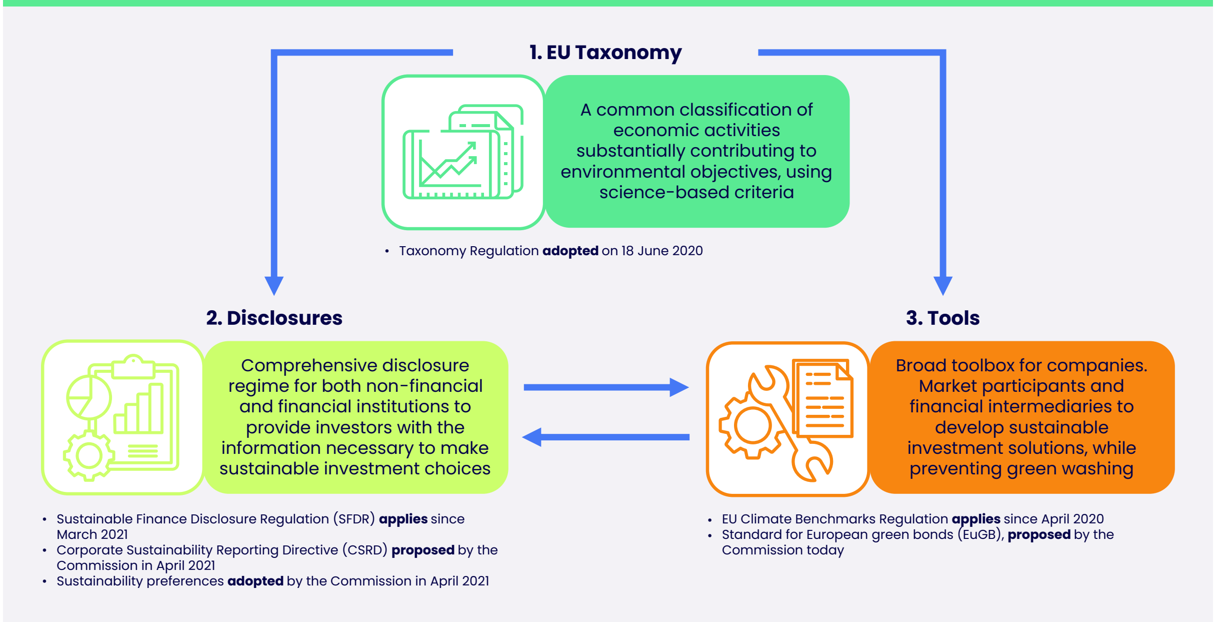
The Sustainable Finance Action Plan established three broad objectives for EU sustainable finance policy, in support of the European Green Deal's overarching aim of making the EU the first climate-neutral continent.

1. **Reorienting capital flows towards a sustainable economy** – closing investment gaps and accelerating financial flows in line with net zero by:
   a. establishing a classification system for assessing the sustainability of economic activities to prevent greenwashing and direct investment to climate solutions;
   b. developing tools to help facilitate the creation of sustainable investment solutions that protect the integrity of the sustainable finance market and trust in it.
2. **Mainstreaming sustainability into risk management** – encouraging investors and other industry actors to consider and embed climate-related risks and opportunities into their investment decision and risk management processes, and transparently disclose on these.
3. **Fostering transparency and long-termism** – enabling investors to assess the credibility of investee companies' transition efforts and their exposure to sustainability risks and opportunities (as well as the impact of companies' activities on sustainability factors) through:
   a. increasing the quality and availability of sustainability-related data by establishing comprehensive sustainability disclosure requirements, increasing the scope of companies subject to reporting rules, and the breadth and depth of disclosure topics
   b. fostering sustainable corporate governance and mitigating short-termism in capital markets.

The EU has established the foundations of a comprehensive regulatory regime for achieving these objectives, based on three core legislative components:

- A classification system to identify sustainable activities in the real economy (the EU Taxonomy);
- Disclosure requirements for a range of financial and non-financial companies (the Sustainable Financial Disclosure Regulation and the Corporate Sustainability Reporting Directive); and
- A set of investment tools to facilitate sustainable investments (Low Carbon Benchmarks Regulation; EU Green Bond Standard).

2018: The foundations of the EU Sustainable Finance Framework



Source: European Commission

These objectives remain relevant six years on. Sustainable finance regulation should seek to foster transparency by ensuring that credible, comprehensive and decision-useful data is made available across the investment chain. This provides a basis to inform investment decisions and engagement activities, and mitigates greenwashing risk. Greater transparency supports the ultimate aim of sustainable finance regulation, which is to facilitate financial flows towards the activities, companies and sectors of the real economy that support the transition to net zero. The achievement of these objectives can also help to foster an enabling environment for investors seeking to make progress against the core alignment objectives of NZIF, namely:

- Transitioning investment portfolios in a way that is consistent with the mitigation goals of the Paris Agreement, focusing on real world decarbonisation (through greater levels of corporate and investor disclosures that facilitate the reorientation of capital towards transitioning assets, and support assets to transition); and
- Increasing investment in the range of climate solutions to enable the transition (via the EU Taxonomy, Green Bond Standard, Low Carbon Benchmarks and other tools).

A broader, overarching aim for EU sustainable finance regulation is the need for interoperability with requirements across other jurisdictions, or at least clarity on how non-EU activities or assets can be addressed with clear guidance on the use of estimates in certain cases. Many investors, and the assets they hold, operate on a cross-border basis and are subject to a patchwork of regulatory obligations. As a first mover and global leader on sustainable finance policy, the EU has benefitted from being able to set a bar for others to follow. Many of the core components of the EU's sustainable finance framework are being replicated elsewhere by other nations and regions, particularly in relation to the rollout of taxonomies. And it is positive to see the ongoing coordination between the European Financial Reporting Advisory Group (EFRAG), the International Sustainability Standards Board (ISSB) and others[9] to maximise consistency between EU and wider international sustainability reporting standards. This will not only help to reduce cost and reporting burdens, it will also help to ensure that investors can assess the transition efforts of their holdings on a more comparable basis and help them meet their own EU reporting requirements.

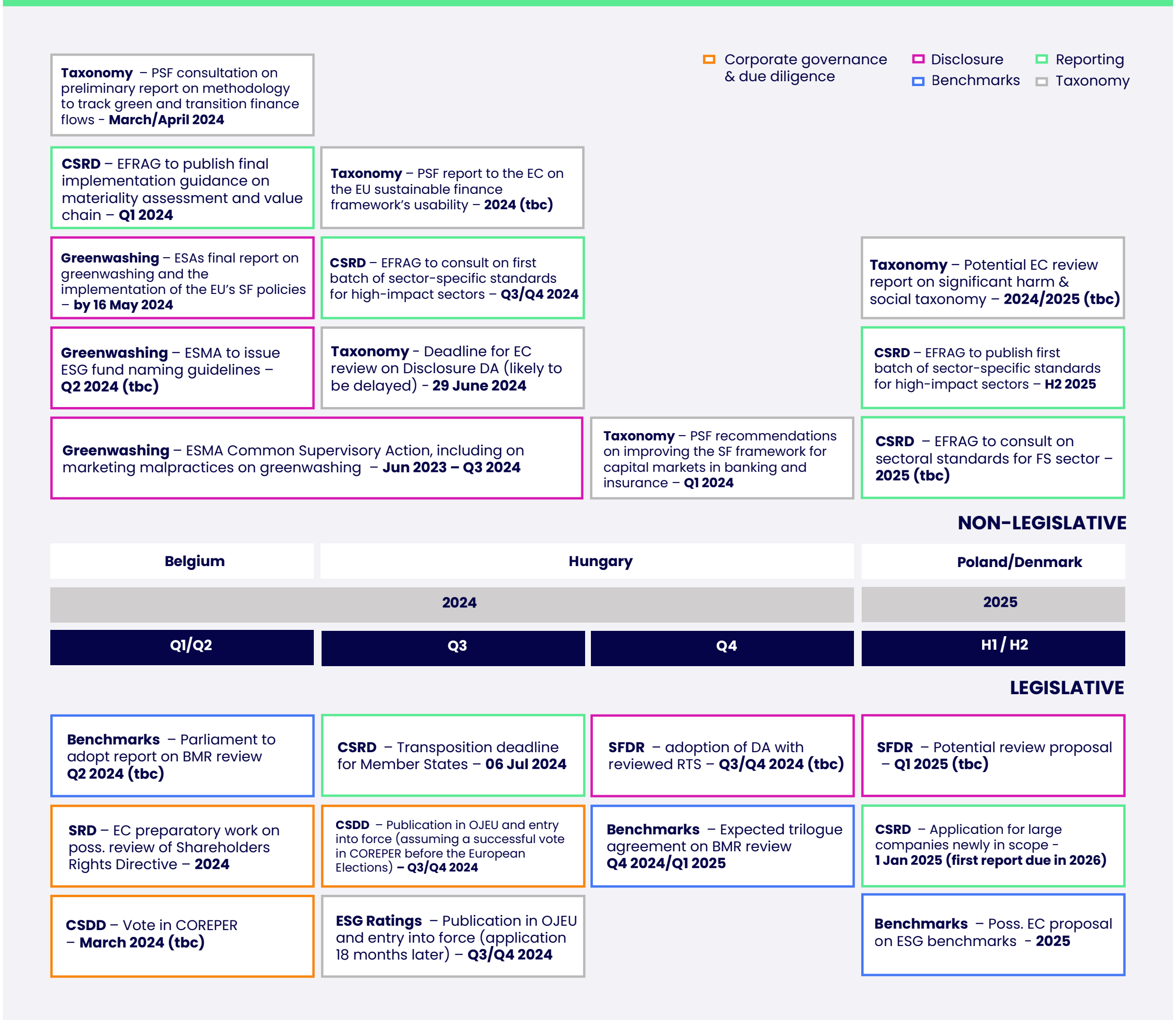
Nevertheless, a balance must be struck between interoperability and preserving the integrity of the EU's sustainable finance framework. There are areas where the EU's ambitious requirements go beyond international norms, for example by requiring disclosure on the impacts of companies' activities on the planet, as well as the impacts of sustainability issues on companies (the 'double materiality' principle). This provides investors and other stakeholders with a much more holistic view of systemic climate risks, and opportunities to mitigate them. However, it is less of a focus on other standards that prioritise a 'financial materiality' lens (a narrower focus on the impact of sustainability issues on companies' business models and strategies). In such cases, the EU should look to prioritise its status as a world leader by maintaining a more rigorous approach, rather than sacrificing ambition in the interest of greater international alignment.

It is also important to consider the limitations of sustainable finance policy – what it cannot achieve and should not be expected to achieve. Sustainable finance regulations are largely concerned with increasing levels of disclosure and transparency. This is an essential prerequisite to action, but alone is insufficient to drive change and real-world impact. Without the right sectoral policy levers and price signals to incentivise investment in high-impact and hard-to-abate activities and sectors, the EU will not be able to achieve its climate goals. Sustainable finance policy must therefore be complemented by, and work in harmony with, comprehensive real economy policies that clarify how key sectors will decarbonise and by when. Ultimately it is these real economy policies that provide incentives for investors to finance the transition of these sectors.

State of play: EU sustainable finance

A clearer understanding of the objectives and pillars of the EU's sustainable finance framework enables assessment of the extent to which it is achieving these objectives, and where enhancements are needed.

Sustainable Finance timeline



Source: FleishmanHillard

As regulations have started to bed in, investors and other market participants have been grappling with a range of usability and implementation-related issues. This is not unusual or unexpected when new regulation enters into force, particularly given the pace and scale of the rollout of sustainable finance initiatives over the 2019-2024 EU mandate. The Commission has recognised these challenges and signalled that addressing them is a high priority.[10] While this is positive, usability and implementation challenges continue to impact the workability of the EU's sustainable finance framework. Ironing out these issues will ease the implementation burdens experienced by financial institutions and corporates and help to streamline and clarify their obligations.

Facilitating access to data

Implementation challenges with the EU's sustainable finance policies have reduced the capacity of investors to access decision-useful data, meet their own reporting obligations, and allocate capital towards the transition. These challenges can be categorised under two broad buckets:

- **Usability issues** – for example, data availability and the ease of interpreting and applying technical criteria/indicators prescribed by regulation, as well as the sequencing of regulatory initiatives.
- **Coherency issues** – including unclear or inconsistent regulatory definitions, concepts and terminology, or duplicative/overlapping requirements.

Specific examples will be highlighted in file-specific recommendations in chapter 6.

Some of these issues (particularly in relation to sequencing and data availability) will be resolved over time. For instance, since the Corporate Sustainability Reporting Directive (CSRD) entered into force in January 2023, a growing number of corporates will be required to produce sustainability-related disclosures.

Other implementation issues will need to be addressed through targeted revisions to existing regulation, for example through the Commission's recent consultation proposing amendments to the implementation of the Sustainable Finance Disclosure Regulation (SFDR).[11] Implementation and usability issues are also hindering the objective of channelling finance towards the transition to net zero, discussed in more detail below. This includes a lack of mandatory transition plan requirements and ongoing uncertainty on concepts and definitions across key regulations (e.g. whether transitioning assets qualify as 'sustainable investments' under SFDR).

Mitigating greenwashing risk and reorienting capital flows towards the transition

To date, EU sustainable finance policy tools have focused primarily on supporting investors and other FMPs to identify and finance activities and sectors that are already broadly aligned with sustainability objectives. But to achieve a whole-of-economy transition, greater investment is needed not just in activities across sectors that are already green, but in the process of becoming green. In other words, sustainable finance tools need to better facilitate 'transition finance' flows.

The Commission acknowledges this, noting that 'sustainable finance is about financing both what is already environment-friendly and what is transitioning to such performance levels over time.'[12] The 2021 Renewed Sustainable Finance Strategy[13] built on the foundations of the Sustainable Finance Action Plan with a focus on measures to incentivise all sectors of the economy to transition to a more sustainable level of performance. This was followed in June 2023 by a communication[14] setting out non-binding definitions and guidance on how the EU's existing sustainable finance tools can be used to facilitate 'transition finance'. The Commission noted that while the EU's legal framework does not define the concept of transition finance, it should be understood as 'the financing of climate- and environmental performance improvements to transition towards a sustainable economy, at a pace that is compatible with the climate and environmental objectives of the EU'.[15]

The Commission's June 2023 communication further defines transition finance as the:

Financing of investments compatible with and contributing to the transition, that avoids lock-in of carbon intensive assets, including:

a. *investments in portfolios tracking EU climate transition benchmarks and EU Paris-aligned benchmarks ('EU climate benchmarks');*

b. *investments in Taxonomy-aligned economic activities, including…transitional economic activities…over a period of maximum 5 (exceptionally 10) years;*

c. *investments in undertakings or economic activities with a credible transition plan at the level of the undertaking or at activity level;*

d. *investments in undertakings or economic activities with credible science-based targets, where proportionate, that are supported by information ensuring integrity, transparency and accountability.*[16]

IIGCC welcomes the Commission's efforts to establish a definition of transition finance for industry to coalesce around, and to clarify the types of activities and investments to which it can be channelled. We also agree that the policy tools needed to support and facilitate transition finance in the EU are already in place. However, as currently designed, these tools can hinder investors' ability to reorient capital in line with the transition and toward relevant investments cited above. For example:

- Paris-Aligned Benchmarks (PABs) and Climate Transition Benchmarks (CTBs) tend to achieve emissions reduction targets through capital and sector reallocation rather than real-world emissions reductions;
- There are concerns around the scientific credibility and integrity of the 'transitional activities' category under the Taxonomy;
- There is a lack of clarity as to whether investments in assets with credible transition plans constitute 'sustainable investments' under SFDR;
- A lack of mandatory transition plan disclosure requirements under CSRD, exacerbated by delays to sector-specific disclosure standards, reduces investors' ability to assess corporate transition efforts;
- The Commission's definition of transition finance treats investments in Taxonomy-aligned activities, undertakings with credible transition plans, and undertakings with science-based targets as separate and independent opportunities, rather than interlinked opportunities. Investments in transitioning assets should have comprehensive entity-level transition plans, underpinned by credible science-based targets (over the short-, medium- and long-term) and activity-level commitments to transition, for example through commitments to increase Taxonomy-aligned CapEx.

In addition, the definition takes a broad view of transition finance as the financing of any and all investments that can contribute to the transition. While there is ultimately a need to ensure the entire economy aligns with the Paris Agreement, we believe that a core aim of transition finance should be to enable financing of the activities and sectors whose transition is most critical for reaching net zero, including high impact and hard to abate sectors.

Interaction between NZIF and EU sustainable finance regulations

Investors should advocate for enabling policy that supports portfolio decarbonisation and climate solutions investment, via engagement with policymakers and regulators.

Under NZIF, transition finance can broadly be considered as finance that supports:

- Investment in climate solutions
- Transitioning assets as assessed against NZIF alignment criteria (achieving net zero; aligned to a net zero pathway; aligning towards a net zero pathway; committed to aligning).

Policy advocacy to promote an enabling environment for the achievement of these objects in the EU context should focus on:

- Climate solutions – Taxonomy; Low Carbon Benchmarks Regulation; Green Bond Standard
- Transitioning assets – Corporate Sustainability Reporting Directive; Corporate Sustainability Due Diligence Directive; Shareholder Rights Directive II; Sustainable Finance Disclosure Regulation
- Products/tools to reorient capital in line with net zero- Low Carbon Benchmarks Regulation; Sustainable Finance Disclosure Regulation; Green Bond Standard

6 Detailed policy recommendations

This section explores some of the main policy barriers to, and opportunities for, net zero alignment identified by investors across specific pieces of sustainable finance legislation. It is not an exhaustive assessment of all the regulations that underpin the EU's sustainable finance framework, but instead focuses on key initiatives that IIGCC has engaged on over the last few years.

6a EU Taxonomy: scaling investment in climate solutions

Summary of barriers:

- Usability issues with the Do No Significant Harm (DNSH) criteria create significant implementation challenges, limiting the ability of investors to assess and invest in the climate solutions defined by the EU Taxonomy. This could also be preventing increased investment in solutions in locations where data is scarcer, because those investments cannot be labelled as climate solutions investments which removes some of the incentives to invest
- Inability to disclose 'partially-aligned' or 'Technical Screening Criteria (TSC)-aligned' (as defined by IIGCC – see below) activities reduces transparency over 'potential' climate solutions – e.g. activities which could make a substantial contribution to climate objectives, but which do not yet meet DNSH criteria
- Assessing the alignment of non-EU companies and exposures with the Taxonomy is challenging due to lack of interoperable legislative references
- Transitional category of activities includes activities that are not compatible with the transition to net zero, undermining the credibility and integrity of the Taxonomy framework

Summary of recommendations (priority recommendations in bold):

- **Commit to a Commission review of the usability of Substantial Contribution and Do No Significant Harm criteria to address implementation issues, in line with the recommendations of the PSF's 2022 data and usability report**
- **Ensure subsequent reviews of the Taxonomy increase the range of Taxonomy-eligible activities in line with the PSF's list of priority economic activities and wider high impact activities**
- **Uphold the scientific integrity of the Taxonomy by ensuring activities that are not compatible with a 1.5c pathway are removed from the 'transitional' category**
- Permit disclosure of 'TSC-aligned' activities under Article 8 of the Taxonomy Regulation, subject to certain conditions
- Publish additional guidance to contextualise Taxonomy-aligned activities as part of a comprehensive entity-level transition plan, and showcase how the existing Taxonomy framework can be used to assess transitioning activities across the wider economy on a voluntary basis

Increasing investment in 'climate solutions' is one of the two core objectives of NZIF (see the box below for IIGCC's definition of climate solutions). The EU Taxonomy is recommended by NZIF as a key standard for assessing climate solutions, but usability issues with the framework have presented challenges when it comes to carrying out these assessments.

"Activities, goods or services that contribute substantially to, and/ or enable, emissions reductions to support decarbonisation in line with credible 1.5°C pathways towards net zero, or that contribute substantially to climate adaptation."

IIGCC's definition of climate solutions

Usability issues with SC and DNSH criteria

A key issue in this context is the usability of the Taxonomy's 'Do No Significant Harm' (DNSH) criteria. The DNSH principle is an important safeguard to reduce the risk of adverse impacts. It helps to ensure that an economic activity making a substantial contribution ('SC') to one environmental objective does not do so at the expense of another. But as currently designed, investors are struggling to implement these requirements. This is partly due to data availability and sequencing issues, with investors being required to report on the Taxonomy-eligibility and Taxonomy-alignment[17] of their investments under SFDR before Taxonomy-related reporting by corporates was made readily available. This will become less of a problem over time, particularly now that CSRD has entered into force. According to Bloomberg, by May 2023, 63% of corporates listed on the STOXX Europe 600 were disclosing both the Taxonomy eligibility and alignment of their activities for financial year 2022 (although this is less relevant for non-EU exposures).[18]

The broader challenges around DNSH have been well documented, including by the EU Platform on Sustainable Finance (PSF).[19]

The PSF's data and usability report highlighted concerns around inconsistent and overly repetitive criteria, ambiguities in DNSH descriptions leading to difficulty measuring criteria (e.g. applying a yes/no outcome) and difficulties applying the criteria to activities in non-EU jurisdictions. The Commission should commit to addressing these issues by reviewing the usability of the DNSH criteria in the next mandate and acting on the recommendations leveraging the recommendations in the PSF's 2022 report on data and usability, including:[20]

- Reviewing and grouping similar criteria together to streamline total number of DNSH criteria;
- Ensuring all SC and DNSH criteria have clear Yes/No outcomes, prioritising quantitative threshold criteria aligned to specific EU regulations/ international standards;
- Limiting the use of subjective language such as 'minimise', 'reduce';
- Supplementing TSC references to EU legislation with international references where possible to promote interoperability

Disclosure of TSC-aligned activities

At present, where DNSH criteria are not met, then the activity as a whole cannot be considered Taxonomy-aligned, and no further details are provided. Given the importance of upholding the DNSH concept for wider environmental objectives, and the scientific integrity of the Taxonomy, it is understandable that such activities should not be considered 'Taxonomy-aligned'. But in light of the challenges investors and corporates have faced in assessing and applying DNSH criteria, there is a risk that actual levels of Taxonomy-alignment are being underreported. Concerns around data availability and usability issues may explain why investors appear to be taking a cautious approach when it comes to pursuing Taxonomy-alignment as part of their sustainable investment strategies. MSCI has reported that the majority of funds with sustainable characteristics or objectives (e.g. Article 8 or 9 under SFDR) have opted not to pursue Taxonomy alignment as part of their strategy - 88% of Article 8 funds and 63% of Article 9 funds surveyed in total.[21]

The current approach prevents investors from accessing decision-useful information on activities that may be 'partially' aligned or 'TSC-aligned' as defined by IIGCC – i.e. that meet the substantial contribution to climate and environmental objectives, but which do not yet meet DNSH criteria. Importantly, this could be leading to underinvestment in sectors and activities critical for the net zero transition. We therefore recommend that the Commission reviews and reopens the Article 8 of the Taxonomy Regulation to enable disclosure of TSC-aligned activities that are not at present meeting DNSH thresholds. We recognise the need to clearly distinguish between disclosure associated with economic activities that qualify as environmentally sustainable, and disclosure associated with activities that qualify as sustainable according to the TSC only. This distinction should be considered as part of the forthcoming review of the Article 8 Delegated Act of the Taxonomy Regulation, and would help users of information to clearly differentiate between full Taxonomy-alignment and partial Taxonomy-alignment. In tandem, Taxonomy-related disclosures under the SFDR will also need to be amended to reflect these changes, given the interlinkages between the two regulations.

Providing flexibility to disclose 'TSC-aligned' activities under the Taxonomy Regulation would be hugely useful for investors seeking to understand the scope for their holdings to improve their sustainability performance, and support stewardship and engagement activities to facilitate such improvements. Reporting should capture the current gaps across the DNSH criteria, and the time-bound actions planned or taken to meet these criteria over a defined timeframe (e.g. as part of transition plan disclosures). IIGCC's recent guidance on investing in climate solutions across listed equity and corporate fixed income[22] endorsed this approach, to help identify and scale investment in climate solutions in the context of the challenges investors are facing when applying DNSH (see the box below).

IIGCC's 'TSC-aligned' classification for climate solutions

IIGCC's climate solution guidance offers several examples of challenges investors face when evaluating potential climate solutions using the DNSH criteria. These included inconsistent and overly repetitive criteria, ambiguities in DNSH descriptions leading to difficulty measuring criteria and a lack of clarity on the fundamental definition of "significant" harm.

For this reason, we are supportive of an additional climate solutions classification of "technical screen criteria aligned" (or "TSC-aligned"). Under the TSC-aligned classification, when an activity meets the substantial contribution TSC for climate change mitigation but does not meet the DNSH criteria, this can still be disclosed and considered a climate solution. Given the importance of upholding the DNSH principle for broader environmental objectives, including the restoration of biodiversity and ecosystems, investors may disclose the status of all other DNSH criteria. For the unmet or unassessed DNSH criteria investors should aim to provide an explanation, due to data availability for example. Investors can additionally indicate the timeframe over which they expect that the criteria will be met.

Using the Taxonomy as a transition finance tool

Increasingly, the Taxonomy – via the CapEx metric - is being used as a forward-looking tool to help facilitate transition finance at the activity-level.[23] In addition to Taxonomy-aligned CapEx, the Taxonomy framework provides a basis for transition finance by recognising a subset of 'transitional activities', defined as activities for which there are no technologically or economically feasible alternatives, and which are compatible with a 1.5c pathway.

In recent years, there have been discussions on the merits of extending the Taxonomy to cover a broader spectrum of economic activities, including significantly harmful activities and those with low or no impact on environmental objectives (a 'transitional' or 'extended' taxonomy). Given the urgent need to address usability issues with the existing Taxonomy, and the additional complexity and implementation challenges that would likely arise, we do not believe this should be an immediate priority for the Commission. While some jurisdictions and regions have adopted extended taxonomies, this is often because they are at very different starting points in their net zero journey. The existing framework already enables users to identify and assess transition activities to some extent, both through the CapEx metric and by using existing substantial contribution and DNSH criteria to identify 'transitioning' activities. As noted by the PSF, the Taxonomy's DNSH criteria provides a technical basis for assessing when eligible activities are operating at a harmful level of environmental performance, while 'transitioning' activities are operating at a level between DNSH and 'substantial contribution'.

Instead, building on the PSF's recommendations, the Commission could consider taking forward non-binding guidance which could set out in more detail how the Taxonomy's existing criteria could be used by companies to 'tell their transition stories and access finance.'[24] More broadly, greater emphasis should be placed on contextualising Taxonomy-aligned CapEx as a core, activity-level component of a comprehensive transition plan (as outlined in the Commission's June 2023 communication on transition finance).

The effectiveness of this approach will increase once the number of Taxonomy-eligible activities across high-impact sectors increases. For example, in the mining sector, this would help to underpin the objectives of the Critical Raw Materials Act. The PSF has highlighted activities in the mining sector as priority economic activities for inclusion,[25] and Climate Action 100+'s Investor Expectation for Diversified Mining[26] classifies commodities such as lithium, copper, nickel and cobalt sector as "Key Transition Materials" (KTMs). The Commission should ensure that forthcoming reviews of the Taxonomy expand the coverage of sectors and activities that are essential for the EU's transition, including those that have already been identified by the PSF but for which TSC and DNSH criteria have yet to be developed.

Lastly, the inclusion of certain activities under the transitional category, notably natural gas and the manufacture of fuel-efficient aircraft, have undermined the scientific credibility of the Taxonomy and its usefulness as a transparency tool. The criteria for transitional activities under the Taxonomy are clearly defined, including the avoidance of carbon lock-in and the development and deployment of low-carbon alternatives, while remaining compatible with the goals of the Paris Agreement. Though such activities will clearly require financing to support their transition (or decommissioning if unable to transition), this should be facilitated through other policy levers. Investors need to be able to rely on the Taxonomy to align portfolios with net zero and reorient capital towards climate solutions. IIGCC recommends that the Commission uses the next three-yearly review of the TSC for transition activities to ensure that those included in the category are fully compatible with each of the underpinning criteria for transitional activities. Those that aren't should be removed.

Case study: Asper Investment Management – advocating to enhance the usability of the Taxonomy for district heating activities

Asper is an independent specialist investment management firm, focused on building sustainable infrastructure businesses. It manages over €1bn of fund commitments on behalf of its clients – most of which are large-scale pension funds and similar prominent institutional investors.

Asper's mission is to 'Build the New' power system, urban energy networks and other sustainable infrastructure, by establishing and growing large-scale sustainable platforms with a meaningful, positive impact on the environment and its communities. Its approach combines infrastructure and private equity approaches: partnering with early-stage developers and supporting them to build large-scale sustainable asset platforms. Asper has established platforms in the onshore wind and district heating sectors across the UK, Ireland, the Netherlands, and Sweden.

Given this focus, Asper has classified all of its funds as Article 9 under SFDR. It has upgraded its ESG due diligence processes to directly assess the EU Taxonomy-alignment of potential new investments, as well as expanding its data gathering and reporting processes to stay informed of EU developments.

One of the key sectors within Asper's focus is district heating, one of the most promising drivers for the decarbonisation of buildings in developed markets, and it currently manage two funds dedicated to district heating investments, totalling c. EUR500m. Assessing Taxonomy-alignment in district heating has unique challenges. While in other energy transition sectors, e.g., onshore wind projects, it is relatively straightforward, the process becomes more intricate for district heating projects. This complexity arises from the involvement of multiple economic activities at each stage (such as production of energy vs distribution of energy) and diverse economic activities for each heat source (such as for fossil fuels, waste heat, bioenergy, batteries, geothermal heat). The complex nature of smart and green district heating and cooling systems, characterized by multiple interconnected networks, diversified heat sources, and various technologies, does not (yet) seamlessly align with the EU Taxonomy's economic activities and criteria.

This misalignment stems from the criteria being overly broad, vague, or challenging to interpret accurately and consistently. Consequently, adjustments are necessary to ensure it effectively serves its intended purpose. To address interpretative uncertainties and advocate for an ambitious and consistent approach within the sector, Asper made the strategic decision to join as a supportive member of the research group 'Applied EU Taxonomy – the case of District Heating', focused on analysing the impact and applicability of the EU Taxonomy on the district heating sector. This group, led by the IVL Swedish Environmental Institute, aims to provide clarity and guidance in navigating the Taxonomy's implications for our industry. Collaborating with stakeholders, including companies, industry associations, and investors in green technologies, Asper provided feedback to EU decision-makers, such as through the Taxonomy Stakeholder Request Mechanism. Asper also has an active partnership with EuroHeat & Power, an international network for district energy, to promote sustainable heating and cooling solutions across Europe.

6b CSRD/CSDDD: enhancing the EU's transition plan framework

Summary of barriers:

- Lack of mandatory corporate disclosure requirements for key climate indicators (including transition plans) limits investors' access to data needed to inform investment decisions and engagement
- Delayed rollout of sectoral standards reduces transparency over key climate-related risks and opportunities and sector-specific transition plan considerations
- Temporary exclusion of financial institutions from the scope of the Corporate Sustainability Due Diligence Directive's (CSDDD) due diligence requirements reduces opportunities for investors to identify and mitigate adverse climate impacts created by investees

Summary of recommendations (priority recommendations in bold):

- **Commit to mandating disclosure of key climate-related indicators under the European Sustainability Reporting Standards (ESRS), irrespective of materiality assessments, including Scope 1, 2, and 3 GHG emissions and disclosures enabling investors to assess the credibility of corporate transition plans**
- **Ensure sector-specific standards for the high impact sectors identified by the European Financial Reporting Advisory Group (including Capital Markets) are ready for adoption by mid-2026**
- **Ensure detailed requirements for the implementation of transition plans under CSDDD align with sector-neutral and sector-specific ESRS**
- **Commit to extending sustainability due diligence requirements under CSDDD to financial institutions in a proportionate and workable manner in the Commission's forthcoming review report**
- Use the next review of the ESRS to introduce additional disclosure indicators that support investors' assessment of climate transition plans, including just transition metrics, short-term emissions reduction targets and climate lobbying activities, and take stock of comparable international frameworks to increase interoperability (e.g. Transition Plan Taskforce)
- Commit to including climate change in the list of adverse sustainability impacts that companies in scope of CSDDD must identify, manage and mitigate as part of any future review of the legislation

Transition plans and emissions reduction targets that align with a 1.5°c world are a core component of the blueprint for driving the transition of the economy. They provide a crucial link between disclosure and action, enabling investors to assess the credibility of corporate decarbonisation strategies, in turn supporting capital allocation and engagement activities. In many ways, embedding effective and coherent requirements for these plans across the regulatory framework is the ultimate aim of the EU's sustainable finance agenda.

The Commission acknowledges that investing in undertakings or economic activities with a credible transition plan at entity and activity-level is a key element of transition finance. It also notes that transition plans are 'emerging as one of the key forward-looking tools that undertakings can use to set out and articulate their targets and the financing needed to reach those targets, and include information on milestones, activities, processes and resources.'[27]

"…an aspect of the undertaking's overall strategy that lays out the entity's targets and actions for its transition towards a climate-neutral or sustainable economy, including actions, such as reducing its GHG emissions in line with the objective of limiting climate change to 1.5°C."

Commission definition of transition plans – sustainable finance communication (June 2023)

The Commission's June 2023 communication highlights investments with a credible transition plan at the entity or activity-level as legitimate sources of transition finance. However, IIGCC proposes that it would be preferable to think about activity-level transition plans as a core component of a wider corporate transition plan (as outlined in point 4 of IIGCC's sector-neutral framework). IIGCC's sector-neutral transition plan guidance sets out the five key components of a credible corporate transition plan:[28]

1	Comprehensive, net zero aligned emissions targets.
2	A credible strategy to deliver those targets.
3	Demonstrable engagement to support the achievement of targets.
4	The contribution to "climate solutions".
5	Supporting emissions and accounting disclosure.

Investor Expectations of Corporate Transition Plans: From A to Zero

The key components of a transition plan identified by IIGCC are broadly captured by the transition plan criteria set out in the sector-neutral European Sustainability Reporting Standards for climate change (ESRS E1) developed by EFRAG.[29] IIGCC welcomed the adoption of the first set of ESRS in July 2023.[30] However, ESRS operates as a disclosure framework; it does not necessarily support investors when it comes to the actual assessment of the credibility of these plans. Our sector-neutral guidance can serve as a credible framework for assessing transition plans, based on the disclosures that companies make under the ESRS, as well as wider alignment criteria such as those established under NZIF. By highlighting the disclosure indicators and data that investors find most useful, it signals what companies seeking to align with the expectations of NZIF signatories should do and what they should disclose.

The box below highlights the degree of alignment between the ESRS E1 and the disclosure indicators established by the Climate Action 100+ Net Zero Company Benchmark (CA100+ Benchmark[31]). The CA100+ Benchmark is an evaluation tool for investor engagement that assesses the adequacy of corporate transition plan disclosures and the degree of alignment of corporate actions with the Paris Agreement.

ESRS E1: gap analysis against the CA100+ Benchmark

The ESRS E1 reporting requirements (including the governance metrics from ESRS 2 and Taxonomy-related disclosures on CapEx and OpEx) are closely aligned with the CA100+ Benchmark, although there are notable differences. Both frameworks are strongly aligned on target setting methodology, 1.5°C alignment and thoroughgoing disclosure expectations on decarbonisation strategy (including the quantification of expected GHG emissions reductions, progress reports and disclosure of offsetting/ GHG removals). Both ESRS E1 and the CA100+ Benchmark capture forward-looking CapEx disclosure requirements, which encourage investment into climate solutions and away from carbon intensive assets. Endorsement of the full gamut of TCFD disclosures is also found in both with ESRS E1 incorporating TCFD into the framework while the Benchmark asks if companies have committed to disclose in line with the TCFD recommendations.

In some respects, ESRS E1 is more comprehensive than the Benchmark (as might be expected, noting that the CA100+ Benchmark is not a disclosure mechanism in itself). For instance, on climate governance, it covers the full range of metrics under Benchmark Indicator 8 (e.g. board oversight and executive remuneration) and probes further, such as how the board is informed on climate risks. However, there are a number of gaps that are not accounted for in ESRS E1. There are no disclosure requirements around climate policy engagement, the 'just transition' is not specifically addressed, and there are no specific indicators relating to emissions reduction target(s) set earlier than 2030.

A high-level table setting out the degree of alignment between the CA100+ disclosure indicators and ESRS E1 can be found in the appendix (Chapter 9.c).

Overall, the disclosure requirements for transition plans set out in ESRS E1 should provide investors with the relevant information to assess corporate transition efforts, support engagement activities and inform investment decisions. However, as highlighted above, there are a number of gaps in the sector-neutral climate standards that should be addressed as part of the next review of the ESRS. In particular, investors would benefit from corporate disclosures on:

- Just transition metrics (e.g. a public commitment to the principles of a Just Transition, assessment of impacts of the entity's transition on communities, workers and wider stakeholders, and actions taken to address impacts);
- Short-term emissions reductions targets (e.g. pre-2030);
- Climate policy engagement (e.g. transparent disclosure of direct and indirect lobbying activities on climate-related policy issues).

More broadly, the next review will provide an opportunity to take stock of wider international frameworks for climate and transition plan disclosures to ensure interoperability. The UK Transition Plan Taskforce's sector-neutral disclosure framework[32] sets out comprehensive and decision-useful disclosure requirements that enable investors to assess the credibility of transition plans. It is noted and welcomed that many of the topics covered in the general sustainability and climate standards established by ESRS are also captured in the TPT framework.[33] But ongoing monitoring of alignment should still be undertaken, particularly in the context of the TPT's forthcoming sector-specific guidance and EFRAG's sector-specific ESRS.

Mandatory disclosure of key climate-related indicators

IIGCC does not support the Commission's decision to require all corporate sustainability disclosures to be subject to materiality assessments, rather than being disclosed on a mandatory basis as originally envisaged. This approach reduces the capacity of investors to meet their own (mandatory) obligations under SFDR, and develop products with specific sustainability and climate-related goals.

Over 90 investors and FMPs signed IIGCC's joint statement with Eurosif, PRI, EFAMA and UNEP FI calling for the Commission to uphold the integrity and ambition of the first set of the ESRS, as envisaged by EFRAG in July 2023 (see box below). The statement makes clear that in light of the EU's climate objectives and investors' own net zero commitments, corporate reporting on GHG emissions, transition plans and climate targets should always be considered material, and hence compulsory for disclosure. We strongly recommend that the Commission commits to mandating disclosure of key climate-related indicators in the next mandate, including Scope 1, 2, and 3 GHG emissions and disclosures enabling investors to assess the credibility of corporate transition plans.

Joint statement on European Sustainability Reporting Standards

On 7 July 2023, IIGCC, together with Eurosif, the Principles for Responsible Investment (PRI), the European Fund and Asset Management Association (EFAMA), the United Nations Environment Programme Finance Initiative (UNEP FI), advocated for the Commission to uphold the ambition of the ESRS as originally envisaged by EFRAG. The statement[34] was signed by a total of 92 investors and other FMPs, and called for the Commission to:

- Maintain key climate disclosure indicators as mandatory, including Scope 1, 2, and 3 GHG emissions and disclosures enabling investors to assess the credibility of corporate transition plans.
- Ensure that environmental and social indicators relevant to SFDR, EU Climate Benchmark Regulation and Climate Benchmarks Delegated Acts, Pillar 3 disclosures and other investor reporting regulations are disclosed by in-scope companies on a mandatory basis.
- Require explanations as to why certain sustainability topics are not considered material for a company.
- Reconsider the fully optional nature of: (i) own workforce disclosures on non-employees; and (ii) biodiversity transition plans to provide investors with information on how companies will align their strategy and business models in line with the EU Biodiversity Strategy for 2030 and Kunming-Montreal Global Biodiversity Framework.
- Ensure maximum possible interoperability of the ESRS with ISSB and GRI Standards, to reduce fragmentation across the global reporting landscape and support cross-border capital flows while upholding the double materiality principle enshrined in CSRD and ESRS.

The need for sector-specific disclosure standards

EFRAG has also been mandated by the Commission to develop a set of sector-specific sustainability disclosure standards. Originally due for adoption in 2024, the Commission announced in February 2024 that the standards will be adopted in June 2026, two years later than originally anticipated.

IIGCC provided feedback on the decision to postpone the adoption of sector-specific standards in late-December 2023.[35] It was noted that while it would have been highly challenging for EFRAG to deliver the 40 sector standards that were originally due by June 2024, significant progress has been made in developing draft standards for several high-impact sectors, which were in a near-final state. This includes oil and gas and diversified mining (both of which IIGCC has already developed its own net zero standards for).[36]

Some of the most critical climate-related risks and opportunities, particularly in high impact sectors, will not be captured by sector-neutral disclosures alone. And in the absence of such disclosures, reporting entities in high impact sectors may struggle to conduct comprehensive materiality assessments on their significant exposures and impacts in line with the sector-neutral ESRS.

While we acknowledge that the standards will now not be adopted until 2026, we urge the Commission to ensure that the standards for all high impact sectors identified by EFRAG are ready for adoption by mid-2026, without further delay. Ahead of this, it is important to use this additional time to gather as much feedback as possible from relevant stakeholders to ensure the standards are fit for purpose and decision-useful. This includes feedback from investors, on topics such as materiality analysis and sector-specific transition plan disclosure.

Additionally, we suggest making sure that the upcoming EFRAG standards for financial institutions (and specifically Capital Markets) include sector-specific considerations for investors' transition plans. NZIF has been developed by and for a broad range of asset owners and asset managers, and taken together the components are widely considered to form the basis for a comprehensive net zero transition plan for investors (and are compatible with existing requirements under CSRD and SFDR). We advise the Commission and EFRAG to consider the components and criteria set out in NZIF when looking to develop supplementary standards for Capital Markets.

From disclosure to action: closing 'comply or explain' gaps through CSDDD

A coherent framework for high-quality and widely available transition plans is essential for investors. But at present, the EU's regulatory regime for transition finance operates as a patchwork of requirements that are not fully consistent with one another, and, critically, are not mandatory (e.g. CSRD). This reduces investors' access to decision-useful data and their ability to meaningfully assess their holdings' transition efforts. And irrespective of whether disclosure requirements are mandatory or not under CSRD, if a reporting company does not already have targets and transition plans in place, it is enough under current requirements for them to simply explain why that is the case. This 'comply or explain gap' is a critical weakness in the EU's transition plan framework. However, other pieces of legislation could help to address these gaps – notably the Corporate Sustainability Due Diligence Directive (CSDDD).

The CSDDD requires a range of EU and non-EU companies to conduct environmental and human rights diligence across their value chains and identify, manage, and mitigate adverse impacts arising from their operations, or those of their business partners. Importantly, it also establishes requirements for in-scope companies to adopt and put into effect transition plans that align with 1.5°C on a mandatory basis. The impact of this requirement is likely to be reduced following increases to the application thresholds for CSDDD.[37] However, the requirements to implement transition plans will still complement the obligations set out in CSRD, which constitute the last stage of the due diligence process (the reporting stage). But for this to happen, it will be important to ensure that the detailed implementation requirements under CSDDD are aligned with the disclosure requirements set out in the sector-neutral and sector-specific ESRS. Under Article 13 of CSDDD, the Commission is required to develop practical guidance to support companies with their implementation of transition plans three years after CSDDD enters into force. It also specifies requirements for the Commission to take forward sector-specific guidance to support CSDDD implementation, although it is unclear whether this relates only to sector-specific due diligence requirements or covers transition plan obligations as well. The need for coherency between the sector-neutral and sector-specific transition plan disclosures to be taken forward by EFRAG is reiterated, and any guidance relating to the implementation of these plans under the CSDDD.

Additionally, while guidance on the implementation of transition plans is welcome, there is a risk that it is interpreted and applied by companies inconsistently which could reduce the comparability of these plans. IIGCC proposes that the Commission consider introducing detailed transition plan requirements under CSDDD as part of the Level 2 standards, aligning closely with CSRD, to ensure a consistent approach to transition plan adoption and implementation across the EU.

Levelling the playing field: including financial institutions in scope of the CSDDD

To maximise the overall effectiveness of CSDDD, the Commission is urged to reconsider the decision to exclude financial institutions from downstream due diligence requirements. As highlighted in the Council and Parliament's joint statement issued in January, there is:

> *"A necessity to develop legal requirements laying down appropriate sustainability due diligence requirements for regulated financial undertakings as regards the activities of their…investees…as well as, as appropriate, liability rules, in order for them to contribute to sustainable development and to the transition to a sustainable economy…".*

IIGCC's position paper on CSDDD,[38] which was developed in consultation with members and which formed the basis of our advocacy on the file, supported an extension of the CSDDD's due diligence provisions to investors. Our support was predicated on the basis that the requirements are proportionate, workable, and clearly differentiate between how investors and non-financial corporates carry out due diligence. Further perspectives on how the requirements could be made workable for financial institutions can be found in the box below. The Commission is asked to consider these points in the context of the review clause on the inclusion of downstream due diligence for financial institutions as set out in the provisional agreement on CSDDD.

Accounting for climate due diligence

IIGCC also strongly supports the inclusion of climate change in the list of environmental harms for which companies will need to conduct environmental due diligence. This requirement did not make it into the final rules, but we recommend that the Commission revisits its inclusion in future. Identifying and addressing adverse climate impacts will help ensure that the CSDDD can function as an 'action and behavioural mechanism' to underpin SFDR, which includes greenhouse gas emissions in the list of mandatory principal adverse impacts (PAIs) that investors are required to mitigate. IIGCC acknowledges that questions have been raised as to how treaties such as the Paris Agreement (which target state actors) could be applied to companies. However, these concerns around the application of international conventions to companies would also apply to the other conventions listed in the Annex of the CSDDD. The Paris Agreement is widely recognised as an international standard for business action, with a considerable and growing number of companies across the globe committing to reducing emissions and building climate resilience in line with its provisions. Initiatives like the Glasgow Financial Alliance for Net Zero and the Paris Aligned Investment Initiative, and Climate Action 100+ are all examples of coalitions whose members have made individual commitments to align with net zero by 2050. The existence of corporate and investor-focused initiatives like these demonstrate that the Paris Agreement can provide a suitable framework for businesses to build on when pursuing their own climate goals.

How can sustainability due diligence requirements work in practice for investors?

In IIGCC's position paper on CSDDD, we emphasised the importance of aligning due diligence requirements for investors with existing, established frameworks that many investors are already applying, notably the OECD's supplementary guidelines for institutional investors. The guidelines set out a risk-based approach to due diligence, where efforts are proportionate to the likelihood and severity of adverse impacts. This is important for institutional investors, who often hold investments in thousands of companies, many of which will be minority shareholdings, and across a range of asset classes and instruments, offering varying levels of control, influence, and access to data. As such, investors do not have the same degree of leverage to address adverse impacts as companies with contractual relationships with their value chains. A risk-based approach allows investors with large numbers of investee companies in their portfolios to engage with the highest-impact companies they hold, enabling targeted and effective risk management.

The CSDDD's civil liability regime, which distinguishes between adverse impacts that are caused, contributed to or linked with companies, is also important in this context. In most instances, investors will be linked to adverse sustainability impacts through their ownership stake in and/or financing of investees, rather than directly causing or contributing to these impacts themselves. Where investors are only linked to adverse impacts, they should not be held liable for these impacts.

For CSDDD to be workable for investors, it must also recognise that the way in which investors undertake due diligence and engage with their downstream value chain is not the same as for companies operating in the real economy. Investors do not have contractual relationships with their investees; instead, they seek to influence their investee's behaviour through active ownership and engagement. Engagement with investees should be recognised as the key lever investors have to engage with and support investees to address their adverse impacts. These activities should be prioritised according to the severity and materiality of the adverse impacts identified and the size of the holdings in, and access to, the investment. Where investors are engaging with their holdings to address and mitigate adverse impacts, these activities should be undertaken in line with their existing obligations under the Shareholder Rights Directive II (SRD II).

6c Improving the functionality of SFDR

Summary of barriers:

- Data availability issues are likely to persist in the absence of mandatory corporate sustainability disclosures under CSRD, reducing investors' ability to meet their reporting obligations under SFDR
- Inconsistencies between key concepts and terminology (e.g. sustainable investments, DNSH) under SFDR and wider regulations (e.g. the Taxonomy) have created implementation challenges
- Entity-level disclosures under SFDR could create duplicative or overlapping requirements where investors are subject to entity-level reporting under CSRD. In addition, the usefulness of aggregated principal adverse impact reporting at entity level under SFDR is questionable (given that exposures are fund-specific)
- A lack of clarity over what constitutes 'sustainable investments' under SFDR has limited scope to invest in transitioning assets and reduced comparability between different sustainable investment approaches
- Lack of minimum sustainability criteria and use as a de facto labelling regime has created confusion in the market over how and when to disclose in line with Article 8 and Article 9, heightening greenwashing risk and reducing comparability of approaches to sustainable investment
- While strategies which passively track PABs or CTBs are expected to disclose under SFDR Article 9.3, active strategies with an objective aligned with the goals of the Paris agreement are expected to disclose under SFDR Article 8, which creates inconsistencies between active and passive approaches

Summary of recommendations (priority recommendations in bold):

- **Clarify the framework to assess transitioning assets, leveraging the definition of 'sustainable investments' under SFDR or the EU Taxonomy to accelerate transition finance flows**
- **Deliver on proposals to introduce product categories/labels under SFDR, including a dedicated category for transition-focused investment strategies**
- Commit to ensuring that climate indicators relevant to SFDR are disclosed by companies in scope of CSRD on a mandatory basis
- Take stock of key terms and concepts in SFDR and wider sustainable finance regulation to ensure consistency between them
- Streamline certain entity-level disclosure requirements (e.g. PAI statements) to reduce reporting burdens and avoid duplication with CSRD
- Modify proposed amendments to the treatment of derivatives under SFDR to ensure separate reporting of financed emissions, long-associated emissions and short-associated emissions. In addition, ensure long and short emissions are not aggregated/netted for SFDR reporting
- Introduce minimum baseline disclosure of key sustainability indicators (e.g. GHG emissions) for all products in scope of SFDR to support a level playing field for sustainability disclosures

SFDR was designed to increase transparency over how investors and wider FMPs consider and manage sustainability-related risks and opportunities, thereby mitigating greenwashing risk. By requiring disclosure on how products with a specific sustainability focus seek to achieve their aims, whether by promoting specific sustainability characteristics ('Article 8') or pursuing sustainability objectives ('Article 9'), SFDR can also help to reorient capital towards net zero.

Following its entry into force in 2021, SFDR has had a significant impact on the market. Analysis by Morningstar shows that funds disclosing in line with Article 8 and 9 under SFDR now hold over €5 trillion in assets under management, accounting for over 55% of the EU investment universe.[39] Recent studies have also indicated that funds reporting in line with Article 8 and 9 have reduced portfolio emissions to a much greater extent than 'mainstream' funds, not just as a result of reweighting to lower carbon sectors and divestment, but also through 'organic' emissions reductions driven by portfolio companies, 'potentially due to pressure from investors'.[40]

Sourcing data from investees

Investors have struggled with well-documented challenges when it comes to implementing the requirements. A key issue has been the lack of available data from corporates to meet reporting obligations under SFDR. This has largely been a consequence of the sequencing of disclosure requirements, with FMPs required to make mandatory sustainability disclosures under SFDR before investee companies were required to report under CSRD. Now that CSRD is in force, the quality and quantity of data in the EU should improve. But, as noted earlier in the report, the Commission's decision to make corporate disclosures under CSRD subject to materiality assessments could exacerbate existing data availability issues.

IIGCC recommends that the Commission revisits this issue in the next mandate, and in line with previous recommendations in this paper, mandates the reporting of key disclosure indicators under CSRD where they support reporting under SFDR. In the absence of mandatory reporting for all companies, it is important for the Commission to provide clear guidelines on how to treat SFDR-related data that has been assessed as non-material by investees, including on the use of estimates and third-party data where information cannot be sourced directly.

Initial guidance[41] from the Commission has indicated that FMPs can neglect to report on SFDR indicators where their investees do not provide disclosures. But it is important to recognise that an absence of reporting does not necessarily correspond with an absence of actual or potential adverse impacts on sustainability factors. Without mandatory disclosure of key climate indicators, there is a risk that adverse climate impacts are left unchecked, undermining the scope for investors to engage with investees and encourage with them to mitigate these impacts.

Upholding consistency between SFDR and wider regulation

Inconsistencies and overlaps between key terminology and concepts in SFDR and wider EU regulations should be addressed as a priority in the next mandate. The Commission has helpfully sought to clarify the relationship between the Taxonomy and SFDR in recent communications,[42] but there remain inconsistencies between the regulations that need to be addressed. These include diverging use of concepts such as 'sustainable investments' and 'DNSH' under the Taxonomy and SFDR respectively, and inconsistencies between the criteria used to assess DNSH under the Taxonomy and those used to assess PAI indicators under SFDR. To address some of these issues, it is recommended that the Commission implements the recommendations proposed by the PSF[43] to establish greater coherency between these metrics, including:

- Clearly distinguishing between environmental DNSH in reference to the Taxonomy and DNSH of SFDR, which is assessed against PAI indicators; and
- Enhancing the consistency of the PAIs with the Taxonomy by aligning the measurement of PAI indicators to the measurement of DNSH criteria under the Taxonomy.

Given that many investors will be required to make entity-level disclosures under both SFDR and CSRD, there is scope for the Commission to reduce reporting burdens by streamlining and consolidating these obligations. This is particularly important in the context of forthcoming sector specific ESRS requirements for financial institutions. Many of our members have also questioned the relevance of producing entity-level statements on PAIs under SFDR. While these statements may help to show how a specific entity's exposure to PAIs evolves over time, their relevance as a means of comparing approaches and exposures across FMPs is debatable, given that exposures to PAIs originate at fund-level and are specific to products. Consequently, it may be helpful to remove PAI disclosure requirements at entity level and place greater emphasis on fund-level PAI disclosure.

Treatment of derivatives under SFDR

Investors and hedge fund managers hold diverse views on how to best account for the role that derivatives and shorts play in net zero investment strategies. Following the publication of the European Supervisory Authorities' (ESAs) final report setting out proposed amendments to the SFDR Regulatory Technical Standards (RTS),[44] some clarity on how derivatives should be approached under the regulations has been provided. Some of the clarifications are helpful but others could be interrogated further. For example, the ESAs propose specific requirements for calculating and netting derivative exposures in PAI calculations by borrowing from the leverage exposure calculations for derivatives in the AIFMD Delegated Regulation. Under this approach, the net long exposure (long positions minus short positions) is taken into account for the PAI computations, and it is floored to zero preventing FMPs from including a netting below 0. When the netting's emissions result is below 0, it can be disclosed additionally as a short position in the PAI's "explanation" column.

In contrast, IIGCC's Derivatives and Hedge Funds guidance[45] argues that to achieve maximum real-economy emissions reductions, economic exposure should not be conflated with net zero alignment. A net-carbon metric reveals the exposure to carbon risk but is less useful for tracking real economy emissions reductions. We suggest that to maximise emissions reductions in the real economy, both long direct exposures and long indirect exposures should target net zero by 2050 to be considered 'aligned with net zero' under NZIF criteria. In line with this guidance, we propose that the Commission modifies the current ESA proposals on the treatment of derivatives under the RTS, and instead require that the following indicators are reported separately:

- Financed emissions: Attributed emissions from companies directly owned by the investor, whether acquired through secondary or primary markets;
- Long associated emissions: Emissions associated with companies where long exposure is gained via prime brokers or derivatives;
- Short associated emissions: Emissions associated with companies where short exposure is gained via prime brokers or derivatives.

Notably, long and short emissions should not be aggregated/netted, for financed emissions nor associated emissions. Asset managers and hedge fund managers can choose to additionally report the aggregate of the direct and indirect long exposures, but they should also report them separately.

Recognising transitioning assets under SFDR

SFDR's role as a transparency framework provides a basis to inform investment decisions and channel capital flows towards net zero. But at present, there is considerable uncertainty in the market as to how transitioning assets and transition-focused investment strategies should be treated under the regime. Its use as a tool for transition finance in its current form is therefore questionable. Indeed, it is perhaps notable that the Commission does not refer to SFDR in its June 2023 transition finance communication (despite including investments in undertakings with transition plans as a legitimate example of transition finance).

This is primarily a consequence of the continued lack of clarity over precisely what constitutes a 'sustainable investment' under SFDR. SFDR defines sustainable investments as investments in:

- an economic activity that contributes to an environmental or social objective;
- provided the investment does not significantly harm any environmental or social objective; and
- that the investee companies follow good governance practices in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.[46]

Many transitioning assets, even those with credible plans to align with net zero, may not presently meet substantial contribution or DNSH criteria as broadly defined under SFDR. This was arguably confirmed in the Commission's response to the ESA's query on whether assets with transition plans qualify as sustainable. In the Q&A, the Commission noted that 'referring to a transition plan aiming to achieve that the whole investment does not significantly harm any environmental and social objectives in the future could…not be considered as sufficient'.[47]

While investors have more discretion to determine the thresholds that constitute intolerable levels of harm under SFDR's general approach, this raises doubts over whether presently high-emitting assets with comprehensive transition plans would be permissible for inclusion within sustainability-focused funds under SFDR.

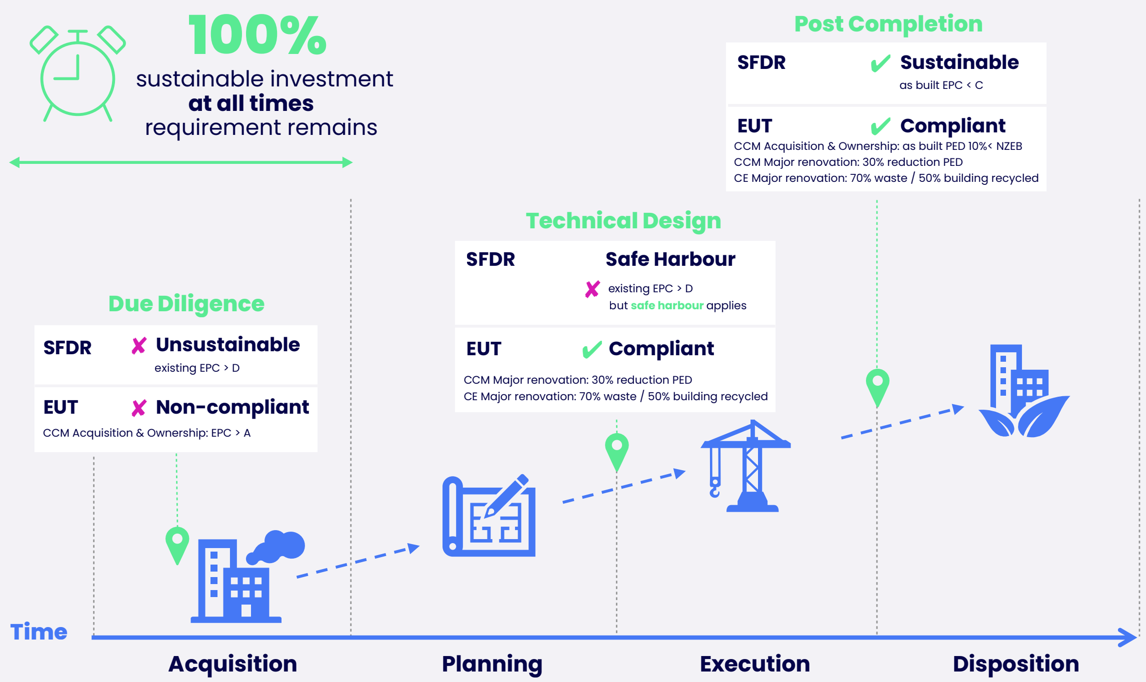
A lack of recognition of transitioning assets has created particular challenges for certain asset classes, notably real estate. SFDR focuses primarily on efforts to reduce the operational emissions generated by real estate assets. It does not account for the 'embodied' emissions associated with the construction, renovation and demolition of buildings.[48] This encourages investors holding real estate assets in funds with sustainability-related characteristics or objectives (particularly those reporting in line with Article 9) to prioritise investment in new buildings, rather than renovating existing ones. Given the urgent need to improve the energy-efficiency of the EU's building stock to keep on track for net zero, this is a suboptimal outcome. For example, the EU's Renovation Wave sets out aims to at least double the annual rate of energy renovations by 2030, which will require an estimated €275 billion of additional investment in building renovation each year.[49]

Case study: DWS – policy barriers to investing in transitioning real estate assets

DWS has used the example of a fund focused on renovating real estate assets as a means of highlighting the potentially conflict between various regulatory rules based on liquids and illiquid investment practice, including SFDR (see graphic below). The need for such activity on a massive scale has been identified as a key priority of the EU Renovation Wave, in order to mee the EU's climate targets. However, the current pace of renovation (approximately 1%) is far from sufficient to reach estimated 35 million energy inefficient buildings by 2030.

There is a clear and urgent need to reorient capital towards renovation activities, but a "Brown to Green" fund would find difficulties in categorising its approach and investment activities as sustainable under SFDR. This is because the initial period from asset acquisition to start of construction works can take months, even years, while lease, planning permission and design issues are resolved. During this part of the hold period, despite the business plan to undertake sustainable refurbishment, the asset is not sustainable under current rules. The recently introduced 'safe harbour' in SFDR RTS addresses only part of the issue, allowing an ongoing refurbishment project aligned with EU Taxonomy to be declared as sustainable. Nevertheless, the issue of the initial period remains, creating issues in reporting such a product under Article 9 of SFDR, potentially creating an impression of it being less impactful than an Article 8 one, and possibly reducing the levels of much-needed investment in renovations.

"Brown to Green" transition



Source: DWS 2023, CCM - climate change mitigation, CE - circular economy, EPC - Energy Performance Certificate, PED - Primary Energy Demand, NZEB - Nearly Zero Energy Building

Source: DWS Group

The lack of clarity over SFDR's approach to assessing transitioning investments has been complicated by divergent approaches at the Member State level. For example, the French financial regulator, the Autorité des Marchés Financiers (AMF) has previously stated that 'a minimum proportion of Article 8 and 9 products' as underlying assets could consist of investments in 'transition assets'. However, the AMF also acknowledged that there is currently no clear-cut definition for such investments and that policymakers should 'design a precise definition of those assets or activities that may qualify as transitioning.'[50]

These barriers create particular challenges for investors using NZIF to align with net zero, and who report on their NZIF-related activities and actions through SFDR. Under SFDR, funds with climate-related targets form a dedicated subset of Article 9 funds, which are required to consist almost entirely of 'sustainable investments' per SFDR's prescribed definition. While the current regime remains open to interpretation, the Commission's proposals to introduce a labelling system under SFDR could help to address these issues. See the box below for IIGCC's initial assessment as to whether funds using NZIF could be categorised as Article 9.

Assessing sustainable investments under SFDR: A guide for investors using NZIF

In our guidance[51] on the interaction between NZIF and SFDR IIGCC proposed that an investment could be considered 'sustainable' for the purposes of SFDR if it qualifies as a climate solution (including Taxonomy-aligned activities). Or, if the investment as a whole can be categorised as 'achieving net zero' or 'aligned' using the NZIF assessment indicators (see sections 7.1, 7.2 and 7.3 of the NZIF implementation guide for detail on the assessment indicators). These investments must also meet the broader tests required under SFDR (DNSH and good governance practices, as well as the Taxonomy's criteria when assessing activity-level sustainability).

IIGCC believes that the above investments could credibly be included in an Article 9 fund. During discussions with members, several organisations proposed that including assets categorised as aligning or committed to aligning could be perceived as contradicting the spirit, if not the letter, of an Article 9 classification. This is because these investees do not yet have a credible, measurable decarbonisation strategy in place to align with the goals of the Paris Agreement. Investors should consider these nuances in the context of an Article 9 classification for net zero products, and how they would justify the inclusion of such assets in a portfolio.

Towards a product labelling system

A well-known concern with SFDR relates to its use in the market as a de facto labelling regime when it was designed to function only as a disclosure regime. SFDR does not prescribe a criteria for assessing the credibility and robustness of sustainable investment strategies and objectives. Instead, the onus is on FMPs to disclose the intended sustainability-related aims of their products (e.g. to promote sustainability characteristics or pursue sustainability objectives) and how these aims are achieved on an ongoing basis.

As a result, FMPs have taken a broad range of approaches to interpreting SFDR and whether their sustainability-focused fund ranges should report in line with Article 8 or 9. This has reduced the scope to meaningfully compare investment approaches and products, and arguably has contributed to an increase in the greenwashing risk that SFDR was designed to mitigate. It has also created considerable confusion in the market, with investors responding to evolving interpretations and a series of Q&As issued by the Commission[52] by reclassifying their fund ranges (mainly 'downgrades' of funds from disclosure under Article 9 to Article 8) to avoid accusations of greenwashing.

In this context, IIGCC welcomes proposals to build on the existing regime by introducing a dedicated product category system, as outlined in the Commission's December 2023 consultation.[53] We also acknowledge and welcome the focus on ensuring that these categories are supported by objective, measurable and robust criteria for assessing funds' sustainability-related characteristics. In our response to the December consultation we were broadly supportive of the proposed categories for products pursuing sustainable impact ('Category A'); products investing in assets that meet credible sustainability standards and/or which pursue a specific sustainability theme ('Category B'; and products pursuing transitioning assets ('Category D').

IIGCC does not support the introduction of a dedicated category for products that exclude investees involved in activities that have an adverse impact on sustainability factors ('Category C'). As noted in our response, exclusions alone are insufficient to constitute a credible sustainable investment strategy and are increasingly being deployed as baseline criteria for a wide range of funds, including those without specific sustainability characteristics and objectives.

IIGCC is strongly supportive of the introduction of a dedicated transition-focused product label under SFDR ('Category D'). This would cement transition-focused strategies as a legitimate – and vital – approach to sustainability and help to mobilise capital towards the net zero transition. Critically, these products must be underpinned by credible criteria to avoid the category becoming another 'catch-all' (much like many funds currently disclosing in line with Article 8).

It is important to ensure that the underlying assets in these funds demonstrate meaningful improvement in their sustainability performance over time. This aligns with the Commission's previous commitments to introduce minimum sustainability criteria for SFRD products, to guarantee *'...the minimum sustainability performance of such products... and incentivise transitional efforts'*.[54] Examples of relevant criteria in this context include:

- Investments in assets with credible transition plans (e.g. under sector-neutral and sector-specific ESRS, and implemented in line with CSDDD) and which are demonstrating progress against these plans. This should include commitments to developing climate solutions at the activity level, for example by increasing levels of Taxonomy-aligned CapEx.
- Stewardship and engagement objectives, including targets to ensure holdings in high-impact/high-emitting sectors are subject to direct or collective engagement activities. This could include engagement with investees with a view to reducing principal adverse impacts, specifically GHG emissions.

While SFDR does require a degree of disclosure on stewardship (e.g. actions taken to mitigate adverse sustainability impacts of investees), the framework would benefit from further targeted enhancements to emphasise its role, both in terms of mitigating the adverse impacts of investments and improving the sustainability performance of holdings over time. This could include greater levels of disclosure of both the quality and quantity of engagements, and the qualitative and quantitative outcomes of engagement (e.g. the results of actions taken/planned). While we would therefore encourage a review of the effectiveness of stewardship and engagement under SFDR, this may be more constructive in the context of any upcoming review of the Shareholder Rights Directive II (see section 6.d. for more information).

We also recommend that the Commission introduces an additional category for funds that invest across a combination of sustainability objectives and strategies aligned with the other categories. This would align with the approach that has been taken by the UK Financial Conduct Authority (FCA),[55] which has opted to include a 'mixed goals' label for its sustainable investment labels regime. Under the FCA's approach, the 'mixed goals' label allows investors to pursue strategies that can combine an investment in already sustainable assets as well as investing in assets that have the capacity to improve over time (e.g. a combination of Categories B and D under the Commission's proposed categories).

This category would also accommodate for other types of products (e.g. multi-asset funds) that could qualify for several categories, as well as supporting investors seeking to align their portfolios using NZIF. For example, under the NZIF, investors set portfolio coverage targets to increase the percentage of their holdings that are i) achieving net zero or ii) 'aligned' with net zero, measured against current and forward-looking alignment criteria, alongside stewardship and engagement actions. In addition, investors using NZIF also aim to increase investment in the climate solutions (e.g. Taxonomy-aligned activities) needed to reach net zero. In practice, such an approach could fall in scope of various labels or categories, and it will be important to provide investors with a degree of flexibility to pursue these blended strategies and account for them in any proposed categorisation system.

IIGCC also supports the introduction of minimum disclosure of key sustainability indicators and PAIs (e.g. Scope 1, 2, and 3 GHG emissions) for all products captured by SFDR, irrespective of their sustainability claims and ambitions. Such an approach could help to level the playing field for investors who may otherwise, through the additional costs and reporting burdens incurred, be placed at a competitive disadvantage by pursuing sustainable investment strategies. Minimum disclosures on a limited number of key sustainability indicators would also increase comparability across funds. However, the requirements should acknowledge that there is no 'one-size-fits-all' list of relevant PAI disclosures across all asset classes (for example for real estate, where asset types can differ considerably) and that data availability and quality across all asset classes will vary considerably.

Managing review timelines: Level 1 and Level 2

It is likely that many of the changes being proposed under the Level 1 and Level 2 reviews of SFDR respectively will take time to enter into force (if they are taken forward). While updates to the detailed Level 2 standards could start to apply from 2025, a functional labelling system for SFDR may not enter into force until later this decade. Given the urgent need to close the EU's net zero investment gap and support the development of transition-focused products, we urge the Commission to bring forward its assessment of the Level 1 framework and implement the necessary changes as early as possible in the next mandate. Better coordination between the Commission and the ESAs on the Level 1 and Level 2 reviews respectively, and clarity on implementation timetables, would provide investors with greater certainty and confidence to accommodate for these changes.

6d Embedding sustainability in stewardship: reviewing SRD II

Summary of barriers:

- Current definitions of stewardship in regulation do not establish links between engagement and sustainability criteria
- Stewardship-related requirements are limited to listed equity under SRD II
- Disclosure requirements only cover how engagement policies are implemented, and neglect disclosure on the progress of engagement activities, their outcomes and their impact on sustainability objectives, as well as the limitations of stewardship and engagement

Summary of recommendations (priority recommendations in bold):

- **Commit to reviewing SRD II under the next mandate and embedding the concept of sustainability more explicitly within the requirements, including the adoption of a revised definition of stewardship and potentially an EU Stewardship Code**
- Expand the range of asset classes accounted for within the EU's consideration of stewardship and sustainability, whether through an expanded SRD II or related directives.
- Promote coherency between, and enhance relevant stewardship-related requirements across, SRD II and SFDR

Stewardship and engagement are some of the most critical tools investors have to facilitate the transition to net zero. NZIF emphasises the role stewardship needs to play as part of a comprehensive strategy to align portfolios with net zero in a manner that leads to real economy decarbonisation. Additionally, investor signatories of NZAM and PAAO commit to implementing stewardship and engagement strategies with clear voting and escalation policies consistent with the goals of the Paris Agreement.[56]

Taking stock of the EU's regulatory framework for stewardship

The extent to which the current regulatory framework for sustainable finance in the EU supports effective stewardship on sustainability issues is debatable. The Commission's Renewed Sustainable Finance Strategy[57] included a commitment to exploring how the Shareholder Rights Directive (SRD II) could better reflect sustainability impacts and global best practices in stewardship guidelines. While an anticipated review of SRD II did not materialise in 2023, this should be progressed in the next mandate, with an emphasis on ensuring the framework supports investor engagement on climate and wider sustainability-related issues.

At present, the definition and concept of stewardship as set out in SRD II is relatively narrow and does not fully account for engagement on sustainability issues. We recommend that the Commission considers embedding sustainability more explicitly within the definition of stewardship, to support investors that have developed stewardship and engagement strategies consistent with ambitions to align assets with net zero by 2050.

A targeted review of SRD II could also help to enhance stewardship regulations, including SFDR. For example, in relation to the requirements on engagement policies under Article 3g of SRD II. Currently, investors in scope of SRDII are required to produce and disclose an engagement policy on a 'comply or explain' basis. These policies form part of the entity-level disclosures that investors need to make under SFDR and can feed through into the consideration of PAIs. However, while SRD II requires disclosure on the processes around engagement with investees, it does not set out provisions for reporting on the quality of these engagements, including the impact or outcome of these engagements. A revised SRD II should require greater levels of disclosure on the outcomes of engagements, which could help to inform PAI reporting under SFDR (e.g. actions taken and actions planned to mitigate the PAIs of investments). Mandatory disclosure requirements for stewardship and engagement under SFDR would also help to strengthen the EU's regulatory approach to stewardship.

Additionally, while SRD II by definition focuses on equity and shareholder rights, it will be important for the Commission to consider stewardship beyond listed equity. This could be addressed separately, for example through the development of an EU-wide Stewardship Code, that could help to establish minimum standards for stewardship in the EU and provide a clearer understanding of what best practice looks like. The UK Stewardship Code may offer a helpful reference point in this regard. It recognises that stewardship is relevant across a range of asset classes and that investors should use the resources, rights and influence available to them to exercise stewardship, no matter how capital is invested. IIGCC has also published its guidance to support investor stewardship across a wider range of asset classes including dedicated bondholder stewardship guidance.[58]

Beyond engagement with companies and assets, the Commission should clarify how investors can engage with governments, policymakers and wider market stakeholders as key levers for investors to effect change and drive the transition. While this is beyond the immediate remit of shareholder 'rights', investors are increasingly recognising the role that 'macro stewardship' has to play, complementing engagement with companies and issuers with a focus on addressing market failures relating to systemic sustainability issues.[59]

Case study: AXA IM – promoting a policy environment that enables investors to exercise their shareholder rights and influence

Stewardship is an important pillar of AXA IM's Responsible Investment strategy, with one of the asset manager's net zero targets relating specifically to the proportion of financed emissions that are subject to engagement and stewardship activities. This is considered to be a critical way of supporting real-world decarbonisation beyond simple portfolio decarbonisation engagement and aligns with the NZIF methodology. With governments and political action at the forefront of the energy transition, AXA IM recently revised its Corporate Governance & Voting Policy to introduce new requirements relating to the climate lobbying activities of high emitters. This builds on the NZIF guidelines, and is intended to promote consistency between publicly stated goals and corporate lobbying.

In this context, one of the priorities of AXA IM's sustainable finance advocacy efforts relates to the promotion of a regulatory environment which does not impede, and even supports shareholder engagement and voting in having an effective impact on investee companies' governance and sustainability strategies.

When it comes to voting at the EU level, while some progress was achieved with the revision of the SRD II in 2020, including on disclosures, investors have continued to face technical obstacles in exercising voting rights. AXA IM highlighted a number of these barriers on their contribution to the responses of several industry groups to a call for evidence on the implementation of SRD II provisions from the European Securities and Markets Authority (2022). The investor continued to express those concerns in 2023 via collective advocacy, contributing to the responses of several industry groups to the SRD II Impact Assessment study conducted by the Commission to highlight key priorities to consider in the revision of the regulation to address those issues.

Another regulation AXA IM focused on in 2023 was the revision of the Listing Act, which the investor highlighted as creating a potential risk of dilution effect resulting from dual class shares, which could undermine the level of board accountability towards the concerns raised by minority shareholders. AXA IM intends to continue its engagement efforts on SRD II and the Listing Act in 2024, including through collective advocacy.

With regards to shareholder engagement, AXA IM sees robust stewardship policies and frameworks as essential for investors to be able to drive and support change across investee companies. AXA has welcomed an increasing understanding from clients and certain regulators of the importance of the "quality" of dialogue as a lever of change beyond, or even before, "quantity" of engagements. At the EU level, guidance arising from SRD II is less well developed, as the regulation states that investors are expected to have an engagement policy in place at entity-level, with implementation remaining largely voluntary at this stage. There is no EU-level guidance that mirrors the principles and provisions set out in the UK Stewardship Code. Many large EU asset managers are signatories to the UK Stewardship Code which AXA IM notes has helped to reinforce their shareholder engagement policies, practices and disclosures. Further guidance at EU level, including a common definition and understanding of reporting that is practicable and effectively supports stewardship understanding across all entities (FMPs, companies and end investors) would be beneficial.

AXA IM sees this advocacy as consistent with, and an enabler of, their responsible investment strategy. It is also consistent with their expectations of their investees.

6e Low Carbon Benchmarks Regulation: delivering real-world impact?

Summary of barriers:

- Aggressive up-front reductions in emissions intensity and 'one size fits all' year-on-year emissions reduction rate reduces the scope for Paris-Aligned Benchmarks and Climate Transition Benchmarks to drive organic emissions reductions
- Low carbon benchmarks fail to account for the sectoral and geographic nuances of the transition
- 'Black box' methodologies stemming from insufficient or incomplete disclosure can increase greenwashing risk
- Limited data availability produced by benchmark constituents (and a lack of focus on forward-looking information) can reduce the ability of benchmark administrators and investors to assess their progress against climate goals

Summary of recommendations (priority recommendations in bold):

- **Commit to reviewing the Low Carbon Benchmarks Regulation, adapting prescriptive methodological requirements to better support real-world decarbonisation and prioritising comprehensive and transparent disclosures**
- Ensure benchmark administrators provide transparent disclosures on benchmark methodologies and ongoing reporting on how the benchmark performs against its stated climate objectives
- Incorporate sectoral and regional based pathways for benchmarks with stated decarbonisation objectives
- Prioritise publicly available data and forward-looking information where relevant (e.g. transition plan disclosures) and allow for integration of alternative alignment metrics

Since their inception in 2019 under the Low Carbon Benchmarks Regulation (LCBR), the use of Paris-Aligned Benchmarks (PABs) and Climate Transition Benchmarks (CTBs) by investors has grown considerably, with an estimated EUR 116 billion in assets managed in funds tracking the benchmarks as of 2023.[60] The Commission has cited low carbon benchmarks as a key policy tool for designing portfolios with decarbonisation objectives.[61]

EU climate benchmarks: Key requirements

The LCBR established two low carbon benchmarks for market use in 2019 – Paris-Aligned Benchmarks (PABs) and Climate Transition Benchmarks (CTBs).

PABs must achieve an annual average decarbonisation rate of at least 7% year-on-year, in line with the IPCC's 1.5°C scenario. In addition, they must reduce the emissions intensity of the investable universe by at least 50% at launch.

CTBs require annual decarbonisation of at least 7%, and a less aggressive up-front reduction in the emissions intensity of the investable universe of 30%.

PABs must exclude companies that derive 1% or more of their revenues from hard coal and lignite; companies that derive 10% or more of their revenues from oil, and 50% or more of their revenues from gas.

Both PABs and CTBs are required to exclude companies involved in activities relating to controversial weapons; companies involved in the cultivation and production of tobacco; and companies found to be in violation of the UN Global Compact principles or the Organisation for Economic Cooperation and Development Guidelines for Multinational Enterprises.

Enhancing the quality of net zero benchmarks

In 2022, IIGCC formed a working group to assess the impact of the LCBR on portfolio alignment activities and suggest ways to improve the next generation of net zero benchmarks. The working group concluded that while PABs and CTBs have helped to increase transparency over net zero-aligned investment strategies and products, they have also led to unintended and undesirable outcomes. In particular, investors noted that PABs and CTBs tend to comply with emission reduction targets through capital reallocation, achieving these reductions by reducing the weight of the highest emitting (and therefore most material) sectors relative to others. This does little to support the real-economy emissions reductions needed to accelerate the transition, which are driven by high-emitting companies with credible transition plans, and which are making progress in delivering against these plans.

In May 2023, the working group published a paper[62] in collaboration with industry experts and index providers, setting out principles for how PABs and CTBs could better support real economy impact and account for the complexities of the net zero transition. The five key principles are set out below.

Enhancing the Quality of Net Zero Benchmarks: Key Principles

IIGCC's paper sets out five key principles, identified by investors, that should underpin the construction of net zero benchmarks:

1. **Prioritise real economy emissions reductions** – to the extent possible, net zero benchmarks should favour avenues to enhance 'organic' emissions reductions, rather than 'paper decarbonisation' achieved through reweighting to low-carbon sectors.
2. **Ensure transparency of benchmark rules** – index providers should set out comprehensive disclosure on benchmark methodologies to mitigate risk of 'black box' approaches, and publish regular, ex-post attribution analysis to demonstrate the extent to which emissions reductions are achieved organically.
3. **Incorporate a sectoral- and regional-based approach** – recognising that different sectors and regions will decarbonise at different speeds, benchmarks should integrate sectoral- and regional scenarios into their methodology to better match decarbonisation trajectories of the real economy and make the benchmark more representative of the investable universe.
4. **Prioritise publicly available data and integrate alternative alignment metrics** – benchmarks should favour constituents with reported emissions data versus estimated data to promote greater levels of corporate disclosure. The incorporation of forward-looking alignment metrics can enhance assessment of transition potential of constituents (e.g. the alignment criteria set out in NZIF).
5. **Facilitate engagement to improve issuer behaviour** - net zero benchmarks should maximise their opportunities for engagement to improve issuer behaviour. While these would differ across asset classes, this can be done by embedding climate performance-related signals into the construction methodology and communicating these to potential benchmark constituents.

As part of the planned review of the Benchmarks Regulation (BMR), the Commission has an opportunity to address some of the design flaws with existing low carbon benchmarks to ensure they better facilitate organic emissions reductions. Our overarching concern with the existing benchmarks is that by establishing prescriptive, 'one size fits all' methodological criteria for PABs and CTBs, the Commission has created a de facto set of financial products. The criteria as currently designed permit very little flexibility for benchmark administrators and investors to develop a broader range of climate objectives and strategies. Instead, they drive homogenous objectives and strategies with high tracking error versus traditional benchmarks, impeding broad adoption by both passive and active investors.

In practice, this can lead to the exclusion of many companies operating in presently high-emitting sectors. It can also reduce the scope to invest in constituents in developing markets, whose transition is most essential for achieving net zero, and for which access to capital is already restricted and demand for transition finance is considerable. Incorporating sectoral and regional decarbonisation pathways, where benchmarks have explicit decarbonisation targets, would help to address this. Low carbon benchmarks should recognise that different speeds of adjustment are required for different sectors and regions. This would make the decarbonisation objectives of the climate benchmarks more reflective of their investable universe.

Subject to legislative progress on the BMR review, IIGCC recommends that the Commission considers removing the prescribed initial reductions in emissions intensity and the annual 7% decarbonisation rate, and instead focus on standardised and comprehensive disclosure requirements from benchmark administrators on:

- the benchmark's climate objective(s);
- how the methodology is designed to achieve the objective;
- the metrics used to assess and report on ongoing progress;
- how the climate objective(s) might impact the risk/return profile vs. the parent benchmark.

This disclosure-focused approach would allow benchmark administrators to continue to launch and manage existing PABs/CTBs should their clients wish to use them, while providing flexibility to pursue multiple approaches to support real-world emissions reductions in a quantifiable manner. It would also leave more room for continued market innovation competition in a rapidly evolving landscape.

Lastly, in the absence of prescriptive methodological requirements, full, transparent disclosure on how constituents of low carbon benchmarks are selected and weighted, and any unique features of the benchmarks (e.g. decarbonisation pathways) will be critical. Disclosures should also include ongoing, ex-post reporting on how the benchmark is progressing against its stated objectives. Additionally, attribution analysis for emissions reductions should be published to help investors understand how the emissions reductions are being derived (e.g. via organic emissions reductions, changes in market capitalisation, sectoral and intra-sectoral allocations).

Prioritising constituents that publicly and directly disclose data (e.g. in line with regulatory disclosure regimes like CSRD) could also help to increase the credibility and quality of low carbon benchmarks. The potential for selection in an index can incentivise corporates to disclose decision-useful information on their climate-related exposures and impacts, particularly important in the absence of mandatory reporting requirements. An amended BMR could set out disclosure requirements for benchmark administrators to report the proportion of constituents who publicly report data (as opposed to relying on estimates), as well as the share of constituents that disclose transition plans that align with 1.5°C. Forward-looking metrics disclosed by constituents should also be considered in the context of benchmark construction process, including whether the constituents have set science-based targets, green CapEx, and other metrics indicating to what extent the constituent is providing investment in climate solutions. This is particularly relevant for corporate bond benchmarks, given that bond markets are more likely to be the providers of working capital to facilitate CapEx for the transition.

7 Bridging the gap: Promoting links between sustainable finance and sectoral policy in the EU

Summary of barriers:

- EU Member States are not implementing sectoral decarbonisation policies swiftly enough, and so are not yet on track to achieve the EU's collective goals set under the Green Deal and Fit for 55[63]
- More clarity is needed from the Commission on how public and private finance tools can work together to close investment gaps and scale financial flows towards key sectors and activities
- For the energy system - the backbone of Europe's transition -the targets for renewable energy deployment and energy efficiency are both necessary and challenging. They will require significant investment at a time of increasing macroeconomic headwinds[64]
- In an increasingly competitive global environment for key industries that drive the green transition and decarbonisation, the EU risks falling behind if funding is not made more accessible
- Beyond 2030, the EU's longer-term trajectory to climate neutrality by 2050 is not yet certain and its overall policy environment remains misaligned with this goal in certain areas

Summary of recommendations (priority recommendations in bold):

- **Member States should swiftly implement the policies established under Fit for 55, to create the price signals and commercial incentives that attract the necessary private investment in the real economy**
- **Developing sector roadmaps will increase transparency over how key sectors of the economy will decarbonise and by when, accompanied by targeted measures to crowd in private finance**
- Strengthening energy security and lowering energy prices for consumers could be achieved by further accelerating the shift to a resilient energy system which is less reliant on fossil fuels and energy providers outside the EU
- Boost competitiveness and attract investment with a plan for Europe's green industrial transition that leverages the Single Market and provides further information on the transition pathways to be taken by key sectors
- Provide greater investment certainty on Europe's long-term trajectory to climate neutrality by setting a science-based 2040 GHG emissions reductions target of at least -90% by 2040 and improving long-term policy coherence and governance

Why real economy policies matter for investors

Sustainable finance policy tools provide transparency on climate-related risks and opportunities, help to mitigate greenwashing risk and inform investment decisions and engagement activities. But they are ultimately a means to an end. The financial sector's ability to support the transition, and thereby create and preserve long-term value, depends on robust sectoral policies. These in turn create the incentives and price signals needed to reorient capital and drive the decarbonisation, resilience and competitiveness of the real economy. Investor signatories of the PAAO and NZAM commit to prioritising real economy emissions reductions across the sectors and companies in which they invest and should seek to engage on real economy policy barriers as part of their policy advocacy strategies.[65]

The EU's Fit for 55 package sets out a comprehensive range of policy measures to decarbonise key sectors of the EU economy and incentivise financial flows in support of the EU's goal of reducing emissions by at least 55% by 2030. And while the majority of the files underpinning the package have now been adopted, additional efforts to enact the package are required. For example, the Commission estimates that although updated draft plans from Member States bring the EU closer to meeting its 2030 targets, current measures are falling short, leading to a projected 51% emissions cut by 2030.[66] The priority now should be to swiftly implement the relevant regulations and delegated acts, particularly where these will provide further clarity and incentives to enable finance flows to high impact sectors.[67]

Creating feedback loops between sustainable finance and real economy policy tools

A more joined-up approach between sectoral and sustainable finance policy tools will help to close financing gaps and ensure investment flows at the pace and scale needed to achieve the EU's 2030 targets and beyond. Sectoral policies should provide clarity on the pathways for sector decarbonisation and measures to crowd-in private investment to accelerate decarbonisation. In turn, sustainable finance policies provide the transparency and tools necessary to support the reorientation of capital towards relevant activities and sectors.

The Commission's June 2023 communication on transition finance was useful in this regard, providing guidance on how investors and corporates can use sustainable finance tools to allocate capital to support the development of key green technologies captured under the Net Zero Industry Act. Additional guidance of this nature, issued on an ongoing basis in the next mandate, could help to increase visibility over corporates' transition financing needs and investment opportunities. This could include greater transparency over how the EU's suite of sustainable finance levers can be used to support the European Green Deal Investment Plan and potentially forthcoming industrial packages.[68]

Prioritise real economy policies for investors

The development of sectoral transition pathways or roadmaps should be prioritised in the next mandate. These roadmaps should set out how key sectors of the economy are expected to decarbonise, and by when, accompanied by detail on how public and private financing mechanisms can enable this. This would in turn increase transparency over key barriers and bottlenecks and investment gaps, providing a basis for targeted policy measures to close these gaps. Additionally, sector-level pathways would serve as a useful benchmark for corporate transition plans and activity-level transition through the EU Taxonomy.

The Commission should commit to taking forward these sector roadmaps, leveraging the EU's Nationally Determined Contribution (NDC) as a blueprint, and prioritising the sectors that will contribute most substantially to the transition. Indeed, there is already a basis for doing this under Article 10 of the EU Climate Law, which requires the Commission to engage with sectors of the economy to prepare indicative voluntary roadmaps to achieve the objective of climate neutrality.[69] An holistic approach should be taken to ensure that the roadmaps are integrated with sustainable finance tools and wider policy initiatives, including the Fit for 55 package and the Net Zero Industry Act.

Beyond sector roadmaps, making progress towards a decarbonised and resilient energy system is another important priority and forms the backbone of Europe's transition. It is essential for the EU's energy security and for lowering prices for consumers, with implications both for industry and for households. At the same time, the necessary EU targets for renewable energy deployment and energy efficiency are challenging. The EU's binding target for 2030 of 42.5% of gross final consumption of energy to come from renewable sources means almost doubling the existing share of renewable energy in the EU.[70] The energy efficiency target to collectively ensure an additional 11.7% reduction in energy consumption by 2030 is similarly stretching.[71] The Commission estimates that Member States are at present on track to fall short of these with projections for 38.6-39.3% of renewables in the energy mix by 2030 and only 5.8% energy efficiency improvements.[72] IIGCC therefore recommends the EU redoubles its efforts to transition its energy system. This could include supporting:

- The effective implementation of accelerated permitting procedures for renewable power generation and manufacturing, addressing investment and deployment barriers;
- The pursuit of more ambitious reductions in energy demand through new and strengthened policies that emphasise energy efficiency first, particularly in the built environment;
- Enhancing the effectiveness and resilience of Europe's energy grid by prioritising energy interconnections between Member States and with nearby partners.

Additionally, there is an increasingly competitive global environment for key industries that drive the green transition and decarbonisation, particularly when it comes to attracting investment. Without further action, the EU risks losing out. For example, while similar amounts of state support are available in Europe as compared to those estimated under the US Inflation Reduction Act, the latter makes it comparatively much easier to access the support – a key factor in the global race for clean investment.[73] There is also a risk that as Member States seek to support domestic industries through the transition with state aid, there is a fragmentation of Europe's Single Market with support from countries with greater fiscal firepower outpacing those with less.

As such, IIGCC encourages the EU to consider launching an industrial decarbonisation deal to focus on greening Europe's industrial base, supported by great clarity on the likely transition pathways for key sectors which will increase certainty and help leverage private sector investment. Furthermore, the Commission should seek to strengthen and revitalise the Single Market to boost competitiveness, in particular by better integrating European energy markets to increase efficiency.

Beyond 2030, the EU's longer-term trajectory to climate neutrality by 2050 is not yet certain and its overall policy environment remains misaligned for key sectors. A key priority for the next EU mandate will be setting Europe's emissions reduction target for 2040. The EU should use this opportunity to reaffirm its commitment to credible, scientifically backed policymaking.

This includes providing greater long-term investment certainty on Europe's trajectory to climate neutrality by setting a science-based 2040 GHG emissions reductions target of at least -90% by 2040, as advised by the European Scientific Advisory Board on Climate Change.[74] Moreover, the long-term coherence of EU and national level policy is essential if Europe is to transition to climate neutrality at the rate required. These policies also need to be communicated clearly and delivered effectively to increase investor certainty and encourage greater capital allocation to Europe over the next 25 years. In the nearer term, the EU must follow through on existing commitments by fully phasing out fossil fuel subsidies, addressing misaligned incentives, and vetting all legislation more rigorously for its consistency with climate goals and to evaluate socio-economic impacts in the context of a just transition. On a slightly longer timeframe, the EU should also align state aid rules with climate objectives.

8 Conclusion

The Commission has achieved a significant amount during the 2019-2024 mandate, establishing a comprehensive framework for sustainable finance that has in many ways set a high bar for other jurisdictions to follow. As we look towards the next mandate, the focus should be on increasing the effectiveness of the sustainable finance framework in practice, supporting investors and corporates with their implementation journeys, and enhancing usability and coherence. Ensuring a more joined-up approach between sustainable finance and sectoral decarbonisation policies will also be essential to reorient capital at pace and scale to the sectors of the economy whose transition will have the greatest impact on emissions.

The next five years will determine whether the EU can deliver on its 2030 targets and set an ambitious target and delivery plan for the years that follow. We hope that the recommendations in this paper provide some insights from investors as to how this can be achieved and serve as a constructive and additive contribution to the discussion on the future of EU sustainable finance policy. We look forward to continuing engagement with policymakers, stakeholders and indeed investors across the EU, and stand ready to support the EU institutions in delivering on the vital objectives of the European Green Deal.

9 Appendix

9a List of recommendations for policymakers

Taxonomy

- **Commit to a Commission review of the usability of Substantial Contribution and Do No Significant Harm criteria to address implementation issues, in line with the recommendations of the PSF's 2022 data and usability report**
- **Ensure subsequent reviews of the Taxonomy increase the range of Taxonomy-eligible activities in line with the PSF's list of priority economic activities and wider high impact activities**
- **Uphold the scientific integrity of the Taxonomy by ensuring activities that are not compatible with a 1.5c pathway are removed from the 'transitional' category**
- Permit disclosure of 'TSC-aligned' activities under Article 8 of the Taxonomy Regulation, subject to certain conditions)
- Publish additional guidance to contextualise Taxonomy-aligned activities as part of a comprehensive entity-level transition plan, and showcase how the existing Taxonomy framework can be used to assess transitional activities on a voluntary basis

CSRD

- **Commit to mandating disclosure of key climate-related indicators under the European Sustainability Reporting Standards (ESRS), irrespective of materiality assessments, including Scope 1, 2, and 3 GHG emissions and disclosures enabling investors to assess the credibility of corporate transition plans**
- **Ensure sector-specific standards for the high impact sectors identified by EFRAG (including Capital Markets) are ready for adoption by mid-2026**
- Use the next review of the ESRS to introduce additional disclosure indicators that support investors' assessment of climate transition plans, including just transition metrics, short-term emissions reduction targets and climate lobbying activities, and take stock of comparable international frameworks to increase interoperability (e.g. Transition Plan Taskforce)

CSDDD

- **Ensure detailed requirements for the implementation of transition plans align with sector-neutral and sector-specific ESRS**
- **Commit to extending sustainability due diligence requirements under CSDDD to financial institutions in a proportionate and workable manner in the Commission's forthcoming review report**
- Commit to including climate change in the list of adverse sustainability impacts that companies in scope of CSDDD must identify, manage and mitigate as part of any future review of the legislation

SFDR

- **Clarify the framework to assess transitioning assets, leveraging the definition of 'sustainable investments' under SFDR or the EU Taxonomy to accelerate transition finance flows**

- **Deliver on proposals to introduce product categories/labels under SFDR, including a dedicated category for transition-focused investment strategies**
- Commit to ensuring that climate indicators relevant to SFDR are disclosed by companies in scope of CSRD on a mandatory basis
- Take stock of key terms and concepts in SFDR and wider sustainable finance regulation to ensure consistency between them
- Streamline certain entity-level disclosure requirements (e.g. PAI statements) to reduce reporting burdens and avoid duplication with CSRD
- Introduce minimum baseline sustainability disclosures for all products to support a level playing field for sustainability disclosures

SRD II

- **Commit to reviewing SRD II under the next mandate and embedding the concept of sustainability more explicitly within the requirements, including the adoption of a revised definition of stewardship and potentially an EU Stewardship Code**
- Expand the range of asset classes accounted for under SRD II
- Promote coherency between, and enhance relevant stewardship-related requirements across, SRD II and SFDR

LCBR

- **Commit to reviewing the Low Carbon Benchmarks Regulation, adapting prescriptive methodological requirements to better support real-world decarbonisation and prioritising comprehensive and transparent disclosures**
- Ensure benchmark administrators provide transparent disclosures on benchmark methodologies and ongoing reporting on how the benchmark performs against its stated climate objectives
- Incorporate sectoral and regional based pathways for benchmarks with stated decarbonisation objectives
- Prioritise publicly available data and forward-looking information where relevant (e.g. transition plan disclosures) and allow for integration of alternative alignment metrics

Real economy

- **Member States should swiftly implement the policies established under Fit for 55, to create price signals and commercial incentives that attract the necessary private investment in the real economy**
- **Develop sector roadmaps to increase transparency over how key sectors of the economy will decarbonise and by when, accompanied by targeted measures to crowd in private finance**
- Strengthen energy security and lower prices for consumers by further accelerating the shift to a resilient energy system
- Boost competitiveness and attract investment with a plan for Europe's green industrial transition that leverages the Single Market and provides further information on the transition pathways to be taken by key sectors
- Provide greater investment certainty on Europe's long-term trajectory to climate neutrality by setting a science-based 2040 GHG emissions reductions target of at least -90% by 2040 and improving long-term policy coherence and governance

9b List of recommendations for investors

Investors are subject to a range of sustainable finance regulations and have a role to play in communicating the impact and knock-on implications of these regulations to their investees. For example, increasing investee awareness of the materiality of sustainability information for informing capital allocation decisions, which can help to promote increases in the availability and quality of climate-related reporting and incentivise corporates to transition. It is also important for investors to complement engagement at the micro-level with 'macro stewardship'. This includes engaging with policymakers and regulators on how the regulations investors are subject to are working in practice, and to identify policy-related bottlenecks to transition finance and net zero alignment.

The NZIF recommends that investors align their direct and indirect policy advocacy efforts towards what is relevant for achieving global net zero emissions by 2050 or sooner. This could include participating in policy advocacy directly or collectively at the global, national and sub-national levels, with a view to addressing barriers to, and capturing opportunities for, net zero alignment created by the wider policy and regulatory environment. NZIF 2.0 describes a range of relevant actions that investors could undertake to support these objectives.

The table below sets out a non-exhaustive list of suggested policy advocacy activities that investors could undertake to support their net zero alignment efforts. The actions can be seen as an EU- and sustainable finance-specific supplement to the action points on policy advocacy outlined in NZIF 2.0.

In the context of EU policy issues, investors should also consider the recommendations set out in the Platform on Sustainable Finance's (PSF) compendium of market practices as a basis for their advocacy and engagement.[75] The report explores how the EU's sustainable finance tools can support and inform the transition efforts of a range of market actors, including investors. Examples of recommended actions for investors include:

- using the EU Taxonomy and upcoming CSRD ESRS to support the definition and implementation of entity-level net-zero targets;
- using the EU Taxonomy KPIs reported by investee companies in the development and management of green and transition financial products;
- using the EU Taxonomy KPIs reported by investee companies to support shareholder engagement and analysis of transition plans and targets at investee company level;
- engaging with data providers to progressively increase the reliability of datasets and their usefulness beyond disclosure obligations; and
- enhancing the integration and uptake of the EU sustainable finance framework within market-led initiatives.

NZIF-related policy advocacy action points	Relevant regulation	Recommended actions
Improved and standardised climate disclosures Mandatory transition plan disclosures	Corporate Sustainability Reporting Directive	■ Engage with EU policymakers to make the case for why investors and wider users of corporate sustainability disclosures require mandatory climate-related disclosures (including transition plans). ■ In the absence of mandatory disclosures, engage with investees to encourage them to assess key climate-related indicators (e.g. transition plans) as material for disclosure ■ Consider escalation measures where investee companies (particularly those in high impact sectors) choose not to assess climate-related indicators as material for disclosure ■ Advocate for the timely development of sector-specific ESRS for financial institutions, leveraging NZIF and the criteria that underpin it as a comprehensive framework for investor transition plans ■ Engage with EU policymakers to make the case for why investors and wider users of corporate sustainability disclosures require mandatory climate-related disclosures by investee companies ■ In the absence of mandatory transition plan disclosure requirements, engage with investees to encourage them to treat key climate-related indicators needed to assess transition plans under ESRS E1 as material for disclosure. ■ Consider escalation measures where investee companies (particularly those in high impact sectors) choose not to assess these indicators as material for disclosure ■ Where captured by CSRD, consider how to use NZIF-related disclosures to fulfil relevant transition plan disclosure obligations ■ In the absence of sector-specific disclosures, engage with investees in relevant high-impact sectors to encourage them to disclose key indicators set out in IIGCC's net zero sector standards
Improving availability of granular sector, regional, and national net zero pathways	Real economy/ sectoral policies	■ Request clarity on sector pathways and financing roadmaps, prioritising those that will contribute most substantially to the transition, and which can underpin company and investor transition plans at the entity-level
Improving shareholder rights to affect corporate strategy and management	Shareholder Rights Directive II	■ Engage with policymakers to highlight approaches for embedding sustainability into stewardship activities (e.g. via reference to the Net Zero Stewardship Toolkit76) and across a broader range of asset classes (e.g. bondholder stewardship)77

Advocating for transition finance to be embedded within regulatory architecture	Various (including the Sustainable Finance Disclosure Regulation)	▪ Consider how best to disclose NZIF-related actions and activities in the context of SFDR, including for funds pursuing emissions reduction objectives (Article 9(3)) and look ahead to how such activities would be disclosed under a new categorisation/labelling regime. IIGCC's 2022 Q&A78 on the interactions between SFDR and NZIF may be a useful resource in this context ▪ Develop investment products under SFDR that align with net zero emissions by 2050 and facilitate increased investment in climate solutions, in line with NZAM and PAAO commitment statements ▪ Engage with the Commission, the ESAs and other stakeholders to highlight implementation barriers to net zero portfolio alignment created by SFDR, either directly or collectively through organisations like IIGCC ▪ Engage with the Commission to promote the need for product labels that support the investment strategies and alignment objectives established by NZIF (e.g. transition and mixed goal categories) ▪ Engage with investee companies to encourage disclosure of indicators relevant for meeting reporting obligations under SFDR ▪ Consider escalation measures where investee companies (particularly those in high impact sectors) choose not to assess climate-related indicators as material for disclosure
Advocating for taxonomies which facilitate climate solutions investment in accordance with the latest climate science, supported by clear and usable criteria, account for transition/ enabling activities, and are interoperable with existing taxonomies Improving disclosure of information relevant to assessing alignment and investment in climate solutions	Taxonomy Regulation	▪ In the absence of mandatory Taxonomy-related disclosures, encourage assets to report Taxonomy-aligned CapEx ▪ Engage with data and service providers to encourage greater availability of Taxonomy-related data ▪ Collect data on TSC-aligned activities and engage with policymakers to advocate for greater transparency to report on these activities ▪ Use Taxonomy-aligned CapEx published by investees to inform the development of/progress against net zero targets at entity-level and the development of transition-focused products ▪ Submit new activities for inclusion in the Taxonomy via the EU's stakeholder request mechanism79 to increase the universe of Taxonomy-eligible activities to invest in. As a priority, submissions should focus on the sectors and activities which have the greatest potential to contribute to the net zero transition, for example mining and the production of key transition materials. ▪ Adopt and maintain a science-based approach to the assessment of Taxonomy-aligned and transitional investments for the purposes of portfolio alignment activities (e.g. excluding natural gas from overall alignment figures) based on scientific and/or technical evidence on new economic activities that could be added to the EU taxonomy or on potential revisions of technical screening criteria of existing activities ▪ Provide direct feedback on usability and implementation challenges with the Taxonomy, and advocate for greater dialogue between policymakers and market participants to address these challenges. This could include submitting requests to revise criteria of existing activities via the EU's stakeholder request mechanism ▪ Engage with regulators and policymakers on the themes and topics highlighted in IIGCC's climate solutions guidance to promote a supportive enabling environment. ▪ Engage with fora such as the Platform on Sustainable Finance to provide inputs on your practical experiences in navigating and implementing Taxonomy-related requirements.

Suitable vehicles for low-carbon investment, including in emerging and frontier markets	Low Carbon Benchmarks Regulation	■ Work with index providers and data providers to develop products based on proposed disclosure criteria outlined above, ensuring transparency in disclosing: i) the benchmark climate objective(s), ii) the index methodology or 'theory of change' for achieving such objectives, iii) the metrics used to assess and report on ongoing progress ■ Where applicable, engage with data and index providers to disclose the relevant net zero sector and/or regional decarbonisation pathways used for the index emissions reduction assessment and targets ■ Work with data and index providers to publish attribution analysis of emissions reductions distinguishing organic emissions reductions from other sources ■ Where possible, encourage relevant entities to engage with index constituents that have not implemented and disclosed transition plans, securing commitments to do so in the future ■ Participate in the review process for low-carbon benchmarks, advocating for the recommendations outlined in IIGCC's paper to enhance the quality of net-zero benchmarks ■ Collaborate with index providers to develop benchmarks with positive weightings for alignment criteria and climate solutions ■ Provide opportunities for collective dialogue between investors and corporates/sovereigns on the links between climate risk, and climate systemic risks
Wider actions	Real economy/ sectoral policy Corporate Sustainability Due Diligence Directive	■ Engage with investees to identify policy-related barriers to decarbonisation across key sectors and engage with policymakers to address these barriers ■ Engage with the Commission to signal investor support for sustainability due diligence requirements, highlighting benefits of extending obligations to financial institutions in a proportionate and tailored way ■ Provide policymakers with examples/case studies of how sustainability due diligence is undertaken by investors (e.g. stewardship and engagement with investees to reduce adverse impacts) and the benefits for financial and sustainability-related risk management

9c Gap analysis table (ESRS E1 and CA100+ Benchmark)

CA100+ Indicators		ESRS Alignment
1	Net-zero GHG Emissions by 2050 (or sooner) ambition	Partial alignment
2	Long-term (2036-2050) GHG reduction target (s)	Close alignment
3	Medium-term (2026 to 2035) GHG reduction target(s)	Partial alignment
4	Short-term (2023-2028) GHG Reduction Targets	No Alignment
5	Decarbonisation Strategy (Target Delivery)	Close alignment
6	Capital Alignment	Close alignment
7	Climate Policy Engagement	No Alignment
8	Climate Governance	Close alignment
9	Just Transition	Partial alignment
10	TCFD disclosure	Close alignment
11	Historical GHG Emissions Reductions	Partial alignment
12	Climate Accounting and Audit	Partial alignment

Endnotes

1 For more information, see IIGCC resource: *Net Zero Investment Framework Implementation Guide*

2 See Commission resource: *Recommendations on facilitating finance for the transition to a sustainable economy (June 2023)*

3 See section 5 for more information on the investor initiatives IIGCC helps to coordinate, and the Net Zero Investment Framework, the leading methodology used by investors to set targets and develop strategies to achieve their net zero commitments.

4 See Commission resource: Communication on the Sustainable Finance Action Plan (2018)

5 For more information, see Paris Aligned Asset Owners initiative.

6 For more information, see Net Zero Asset Managers initiative.

7 Due to be published Q2 2024.

8 Commitment statements for PAAO and NZAM can be found here and here.

9 For more information, see the ISSB statement on alignment between EFRAG and ISSB standards (July 2023).

10 See Commission resource: *Enhancing the usability of the EU Taxonomy and overall EU sustainable finance framework* (June 2023)

11 See Commission resource: *Targeted consultation on the implementation of SFDR* (September 2023)

12 See Commission resource: *Recommendations on facilitating finance for the transition to a sustainable economy* (June 2023)

13 See Commission resource: *Communication on Strategy for Financing the Transition to a Sustainable Economy* (July 2021)

14 See Commission resource: *Sustainable finance package* (June 2023)

15 See Commission resource: *Recommendations on facilitating finance for the transition to a sustainable economy* (June 2023)

16 Ibid.

17 Taxonomy-eligible activities are economic activities that are capable of making a substantial contribution to one or more of the Taxonomy's six environmental objectives (including climate change mitigation and climate change adaptation). Taxonomy-aligned activities are activities which meet all three of the Taxonomy's criteria (substantially contributing to environmental objectives in line with TSC; DNSH to other environmental objectives; complying with minimum social safeguards as described in the Taxonomy Regulation.

18 See Commission resource: *Recommendations on facilitating finance for the transition to a sustainable economy* (June 2023)

19 See Platform on Sustainable Finance resource: *Recommendations on Data and Usability* (October 2022)

20 See UK Green Technical Advisory Group resource: *Streamlining and increasing the usability of DNSH within the UK Green Taxonomy*

21 See MSCI report: *Funds and the State of European Sustainable Finance* (July 2023)

22 See IIGCC resource: *Investing in climate solutions: listed equity and corporate fixed income* (September 2023)

23 See Commission resource: *Recommendations on facilitating finance for the transition to a sustainable economy* (June 2023)

24 See Platform on Sustainable Finance report: *Extended Environmental Taxonomy* (March 2022)

25 See Platform on Sustainable Finance resource: *Recommendations on Data and Usability* (October 2022)

26 See Climate Action 100+ resource: *Investor Expectations for Diversified Mining* (September 2023)

27 See Commission resource: *Recommendations on facilitating finance for the transition to a sustainable economy* (June 2023)

28 See IIGCC resource: *Investor Expectations of Corporate Transition Plans* (March 2023)

29 See IIGCC response: *EFRAG consultation on draft European Sustainability Reporting Standards* (August 2022)

30 See IIGCC statement: *European Sustainability Reporting Standards* (July 2023)

31 See CA100+ resource: Net Zero Company Benchmark

32 See TPT resource: *Sector-neutral Disclosure Framework* (October 2023)

33 See TPT resource: *TPT-ESRS comparison* (October 2023)

34 See IIGCC statement: *Publication of the sector-neutral ESRS* (July 2023)

35 See IIGCC statement: *Postponement of sector-specific ESRS* (December 2023)

36 See Climate Action 100+ resource: *Investor Expectations for Diversified Mining* (September 2023)

37 EU-based companies with over 1,000 employees and annual net worldwide turnover of €150mn will be in scope of CSDDD, likely from mid-2027 to mid-2029. The scope of application for CSRD for large EU-based companies is much broader (two of the three criteria of annual net turnover of €50mn; balance sheet assets exceeding €25mn; 250 employees).

38 See IIGCC resource: *CSDDD position paper* (October 2023)

39 See Morningstar report: *SFDR Article 8 and Article 9 Funds: Q3 2023* (October 2023)

40 See paper: *Imposing Sustainability Disclosure on Investors: Does it Lead to Portfolio Decarbonization?* (December 2023)

41 See Commission Q&A: *Adoption of the ESRS* (July 2023)

42 See Commission resource: *Interpretation and implementation of legal provisions of the Taxonomy and links to SFDR* (June 2023)

43 See Platform on Sustainable Finance resource: *Recommendations on Data and Usability* (October 2022)

44 See ESAs report: *Final report on draft Regulatory Technical Standards, SFDR* (December 2023)

45 See IIGCC resource: *Derivatives and Hedge Funds Guidance* (February 2024)

46 See Commission regulation: *SFDR level 1* (December 2019)

47 See ESAs consolidated Q&A: *SFDR RTS* (January 2024)

48 See INREV paper: *Falling through the cracks: SFDR's impact on real estate investment* (January 2023)

49 See Commission Q&A: *Renovation Wave* (October 2020)

50 See AMF paper: *Proposal for minimum environmental standards for financial products belonging to the Art.9 and 8 categories of SFDR* (February 2023)

51 See IIGCC resource: *SFDR/NZIF Q&A*

52 See ESAs consolidated Q&A: *SFDR RTS* (January 2024)

53 See IIGCC response: *SFDR Level 1 consultation* (December 2023)

54 See Commission resource: *Communication on Strategy for Financing the Transition to a Sustainable Economy* (July 2021)

55 See FCA Policy Statement: *SDRs and investment labels* (November 2023)

56 Commitment statements for PAAO and NZAM can be found here and here.

57 See Commission resource: *Communication on Strategy for Financing the Transition to a Sustainable Economy* (July 2021)

58 See IIGCC resource: *Net Zero Bondholder Stewardship Guidance* (June 2023)

59 See Aviva Investors AIQ: *Macro stewardship*

60 See Commission resource: *Recommendations on facilitating finance for the transition to a sustainable economy* (June 2023)

61 Ibid

62 See IIGCC resource: *Enhancing the Quality of Net Zero Benchmarks* (May 2023)

63 See Commission press release: *Commission calls on Member States to improve their National Energy and Climate Plans to ensure collective achievement of the EU´s 2030 targets* (December 2023)

64 See Commission resource: *Renewable energy targets*; and Commission regulation: *Energy Efficiency Directive*

65 Commitment statements for PAAO and NZAM can be found here and here.

66 See Commission press release: *Commission calls on Member States to improve their National Energy and Climate Plans to ensure collective achievement of the EU´s 2030 targets* (December 2023)

67 E.g. guidance on investment under the Energy Efficiency Directive (EED), guidance on renewable acceleration areas under the Renewable Energy Directive (RED), and guidance on increasing finance for energy performance renovations under the Energy Performance of Buildings Directive (EPBD).

68 See Antwerp Declaration for a European Industrial Deal

69 See Commission regulation: *European Climate Law* (July 2021)

70 See Commission resource: *Renewable energy targets*

71 See Commission regulation: *Energy Efficiency Directive*

72 See Commission press release: *Commission calls on Member States to improve their National Energy and Climate Plans to ensure collective achievement of the EU´s 2030 targets* (December 2023)

73 See Bruegel policy brief: *How Europe should answer the US Inflation Reduction Act* (February 2023)

74 See European Scientific Advisory Board on Climate Change report: *Scientific advice for the determination of an EU-wide 2040 climate target and a greenhouse gas budget for 2030–2050* (June 2023)

75 See Platform on Sustainable Finance: A Compendium of Market Practices (February 2024)

76 See IIGCC resource: *Net Zero Stewardship Toolkit* (April 2022)

77 See IIGCC resource: *Net Zero Bondholder Stewardship Guidance* (June 2023)

78 See IIGCC resource: *NZIF/SFDR Q&A* (April 2022)

79 See Commission resource: *Stakeholder Request Mechanism* (October 2023)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