CLEARY GOTTLIEB

6 March 2024

Climate and the Financial Sector

This weekly newsletter highlights climate-related regulatory, litigation and enforcement developments relevant to the financial sector.

General

28 February 2024 [EU] – **CSDDD Postponed**

The Corporate Sustainability Due Diligence Directive (CSDDD) was originally proposed by the Commission in February 2022 and has been under negotiation for two years, culminating in a provisional political agreement reached between the Council and the Parliament, to be confirmed by a vote of EU Member States. In particular, the proposed CSDDD would have introduced a sustainability due diligence obligation for large EU and non-EU companies to identify, prevent, and mitigate environmental impacts of their operations, their subsidiaries, and their value chain. Failure by EU Member States to vote in favour of the provisional agreement will lead to renegotiation of the draft CSDDD and further delays. [link]

1 March 2024 – **EFRAG Publishes a Second Q&A on technical clarifications for ESRS**

Following the launch of the Q&A platform in October 2023, EFRAG has released a second Q&A aimed at collecting views and information from stakeholders on the implementation of ESRS. EFRAG's responses are categorised as follows: "crosscutting", "environmental", "social" and "other". EFRAG announced that it will continue to issue further comment letters. [link]

27 February 2024 – **Parliament Adopts Revised Directive on Environmental Crime**

The Parliament adopted in plenary, in first reading, a Directive revising the Environmental Crime Directive (2008/99/EC). The revised Directive includes an updated list of environmental crime offences (which will include illegal timber trade and depletion of water resources), harmonised types and levels of sanctions (e.g. individual offences punishable by up to ten years imprisonment and fines for companies up to 5% of worldwide turnover or 40 million euros), measures to strengthen international investigation and prosecution, improvements in the collection of statistical data and measures to improve national enforcement chains. The Council will now have to consider the revised Directive. [link]

14 February 2024 [EU] – **EU Council Publishes Text of Political Agreement on Proposed Regulation on ESG rating activities**

The EU Council has published the final compromise text of the proposed regulation on ESG rating activities. On 5 February 2024, the Council and the Parliament had previously reached a provisional agreement on this proposal, which aims to boost investor confidence in sustainable products, the content of which is reflected in the final compromise text.

The agreement introduces a principle of separation of business and activities, either through a separate legal entity for certain activities or through clear separation of activities and measures to avoid conflicts of interest.

Under the proposed rules, ESG rating providers established in the EU will have to be authorised and supervised by ESMA, and must comply with a number of transparency requirements regarding their methodology and sources of information. However, ESG rating providers established in a third country will have to either (i) obtain endorsement of their ESG ratings by an EU-authorised ESG rating provider, (ii) obtain a recognition based on certain quantitative criteria, or (iii) be included in a dedicated EU register based on an equivalence decision.

A lighter temporary and optional registration regime of three years has been introduced for small companies and groups providing ESG ratings, with small ESG rating providers opting for the lighter regime benefiting from supervision fees proportionate to the level of supervision by ESMA.

The Council invited the Permanent Representatives Committee to approve the text of the draft regulation with a view to reaching a first reading agreement with the Parliament. [link]

Asset Management

15 February 2024 [EU] – **ESMA Publishes a Paper on ESG Funds during the 2020 COVID-19 Market turmoil**

The ESMA has published a Working Paper on the performance and flows of ESG UCITS funds relative to their non-ESG peers in a period of financial distress (i.e. the first wave of COVID-19), analysing in particular the “hedging” reasons that may drive investors’ preferences towards ESG funds in times of market stress. It focuses on EU-domiciled UCITS funds that can be identified as ESG or not, or that have an ESG rating, distinguishing funds based on different sustainability characteristics. The selected period is 19 February 2020 to 30 June 2020.

The paper finds that ESG funds in the US outperform non-ESG funds during market crises but underperform in non-crisis periods, with the underlying hypothesis being that ESG funds hold up better during market crises periods because they dampen the downside risk.

First, the analysis finds that ESG funds are associated with higher net returns (more specifically, higher returns during the stress period but lower returns during the recovery). Second, ESG funds with the highest ESG ratings have higher net flows, with the latter also experiencing higher net flows during the stabilisation period.

ESMA concluded that ESG active UCITS outperformed non-ESG active UCITS during the ten weeks of the first COVID-19 outbreak. Funds with a high ESG rating also had higher returns over the whole period compared to funds with a low ESG rating. However, being an ESG fund and having a high sustainability rating is not associated with excess performance. [link]

Insurance

29 February 2024 [EU] – **EIOPA Publishes a Paper on Natural Catastrophe Protection Gaps**

EIOPA has published a revised version of its paper which focuses on addressing natural catastrophe protection gaps. While recognising that insurance markets are different across Europe, EIOPA has identified the following solutions to limit the gaps:

- Increasing risk awareness and coverage, for example through digital tools that can more easily present the risks to which consumers are exposed;
- Improving consumer understanding and product comparability; and
- Reducing insurance premiums by requiring risk mitigation measures to limit insurers’ exposure to risk and incentivising consumers to take out coverage for natural catastrophes. [link]

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