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КРИТИЧКИ ОСВРТ НА ЗАХТЕВЕ У ВЕЗИ СА ИЗВЕШТАВАЊЕМ О КЛИМИ У СЕКТОРУ ФИНАНСИЈСКИХ УСЛУГА

Апстракт: Potpisivanje *Pariskog sporazuma* i usvajanje *Agende za održivi razvoj UN 2030*, ukazuju na radikalnu promenu globalnih stavova prema klimatskim promenama i održivom razvoju. Održivost i prelazak na nisko-ugljeničnu i efikasniju upotrebu resursa ključni su napori u obezbeđivanju dugoročne konkurentnosti ekonomije Evropske unije (EU). Rad se bavi izazovima sa kojima se EU suočava prilikom realociranja tokova kapitala ka održivim ulaganjima i nudi kritički pregled novih EU smernica za kompanije u vezi sa izveštavanjem o klimi i EU taksonomije. S obzirom na to da su identifikacija, modeliranje i upravljanje rizicima u osnovi industrije osiguranja, a da rizici povezani sa klimatskim promenama predstavljaju danas najznačajniji dugoročni rizik, posebna pažnja data je obelodanjivanju informacija povezanih sa klimom iz perspektiva sektora osiguranja.
Кључне речи: Održive finansije, EU taksonomija, obeloganjivanje ESG informacija, izveštavanje u vezi sa klimatskim promenama, sektor osiguranja.

A CRITICAL REVIEW OF THE CLIMATE-RELATED REPORTING REQUIREMENTS IN THE FINANCIAL SERVICE SECTOR

Abstract: The signing of the *Paris Agreement* and the adoption of the *UN 2030 Agenda for Sustainable Development* proved a radical change in global attitudes towards the climate change and sustainable development. Sustainability and the transition to a low-carbon and more resource-efficient are the key endeavours in ensuring long-term competitiveness of the EU economy. The paper deals with the challenges the EU faces with while reallocating capital flows for sustainable investments and offers a critical overview of the new EU guidance for companies on climate-related reporting and the adoption of the EU taxonomy. Given that risk identifying, modeling and managing are at the core of the insurance industry, and that the risk related to climate changes are today the most significant long-term risk, a special attention is given to the disclosure of climate-related information from the perspective of the insurance sector.
Key words: Sustainable finance, EU taxonomy, ESG disclosure, climate-related reporting, insurance sector.

1. INTRODUCTION

The European Union (EU) is a global leader regarding its attempts to integrate sustainability in its regulatory framework. By adoption of the *European Green Deal* (European Commission, 2019), the EU seeks to make Europe the

first climate neutral continent by 2050. In order to overcome the existing lack of long-term perspective, promote transparency and sustainability in financial markets and mobilize finance towards sustainable growth, the European Commission has established the EU *Action Plan for Sustainable Finance (*European Commission, 2018). Sustainable finance, understood as the process of considering environmental, social and governance (ESG) issues when making investment decisions in the financial sector, should support a resilient economy and a sustainable recovery from the global pandemic impacts. With an aim to link more closely finance with sustainability, the *EU Action Plan for Sustainable Finance* is based on a comprehensive strategy and underlying activities directed to: a) reorienting capital flows towards a more sustainable economy, b) mainstreaming sustainability into risk management, and c) fostering transparency and long-termism (European Commission, 2018). The EU Commission developed a legislative proposal package that consists of the EU sustainable finance taxonomy, EU green bond standard, corporate disclosure of climate-related information, the EU climate benchmarks and benchmarks' environmental, social and governance (ESG) disclosures, as well as the sustainability disclosure obligations for companies operating in the financial service sector.
Considering these attempts of the EU towards a relocation of capital flows for sustainable investments, the paper offers a critical overview of the new EU guidance for companies on climate-related reporting and the adoption of the EU taxonomy, with a focus in the insurance industry. The paper is structured as follows: the second section of the paper examines the key challenges to companies imposed by climate-related disclosure requirements as the most demanding area of ESG reporting. The Section 3 investigates the EU sustainable finance taxonomy, and offers a critical overview of its main elements from the perspective of its projected outcomes, while Section 4 analyses the disclosure of climate-related information from the perspective of the insurance sector. In the last section, the main conclusions are summarized and the messages and implications for corporate and financial sectors, policy makers and investors are pointed out.

2. EU GUIDANCE FOR COMPANIES ON CLIMATE-RELATED REPORTING

Traditional financial reporting, based dominantly on monetary disclosures and primarily ex-post oriented, is no longer sufficient to meet the information needs of investors, creditors and other stakeholders. In addition to financial reporting, non-financial reporting becomes a *conditio sine qua non* in corporate reporting. The goal of sustainability reporting should be "to measure the financial, social, and environmental performance of a company" (Milne & Gray, 2013). These three key aspects of corporate reporting became the basis for establishing the guidelines of the Global Reporting Initiative - GRI, one of the most well-known organizations dealing with the issues of sustainable development of business entities (Stojanović-Blab & Blab, 2017; Wagner & Seele, 2017; Bednárová, Klimko, & Rievajová, 2019). In addition to the GRI, the International Integrated Reporting Committee, which was renamed the International Integrated Reporting Council (IIRC) a year later, has an important role in creating guidelines for an comprehensive company reporting since 2010. The main objective of the IIRC is to establish guidelines for the integration of financial and non-financial information to meet the informational needs of users (primarily investors), providing an explanation of what factors affect the organization's ability to create value over time, ie to ensure sustainable development (Rinaldi, Unerman, & de Villiers, 2018; La Torre, Bernardi, Guthrie, & Dumay, 2019). Certainly, many other national and international organizations also contribute significantly in this area, for example the Sustainability Accounting Standards Board (Shoaf, Jermakowicz & Epstein, 2018), the Climate Disclosure Standards Board (2019), the EU Eco-Management and Audit Scheme (EMAS), etc.
The European Commission also timely began to establish guidelines and recommendations in this area, first issuing a new "Accounting Directive", i.e. Directive 2013/34/EU (European Parliament and the Council of the European Union, 2013), which was amended a year later with the Directive 2014/95/EU (hereinafter Non-Financial Reporting Directive - NFRD) (European Parliament and the Council of the European Union, 2014), with early application from January 1, 2018 (ie for the financial year 2017). In order to further support companies in the disclosure of non-financial information, the European Commission adopted specific (non-binding) *"Guidelines on non-financial reporting (methodology for reporting non-financial information)"* in 2017 (European Commission, 2017), which were supplemented by special guidelines on reporting climate-related information two years later (European Commission, 2019). The adoption of guidelines for non-financial reporting in both documents is the result of one of the goals of the *Action Plan for Financing Sustainable Growth* (European Commission, 2018a).
The article 1 of the NFRD states that companies concerned: "[…] shall include in the management report a non-financial statement containing information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters […]", respecting the folowing reporting principles:

- *to disclose material information*, whereby the assessment of its materiality should take into account a variety of factors, such as: the entity's business model, its strategy and major risks; sector affiliation; expectations of major investors, etc. The materiality of some non-financial information should be assessed in the context of other information, which obviously gives a relatively wide room to assess which information should be consider material and which not;

- *disclosed information should be fair, balanced and understandable*. This principle practically means that all information should be disclosed based on facts (which clearly distinguishes facts from attitudes or interpretations), impartially (without distinguishing whether they have favorable or unfavorable aspects from the company's point of view) and in common business language, combining narrative and quantitative reporting and visual presentation with the necessary explanations of the key information or the method used to measure a specific KPI;
- *disclosed information should be comprehensive but concise*, to achieve an appropriate balance;
- *strategic and future-oriented*, ie the report is expected to provide relevant information of primarily non-financial nature on the strategy and objectives of the reporting entity and the manner of its implementation, but also to explain short-term, medium-term and long-term implications on the entity;
- *stakeholder orientated.* Opposed to IFRS, which focus on investors and creditors, the guidelines for non-financial reporting suggest that the information needs of all relevant stakeholders should be taken into account in the preparation of this report (but not the needs and wishes of individual or atypical users with inappropriate information needs);
- *consistency and coherency with other elements of the management report.*

The EU Guidelines on non-financial reporting from 2017, in addition to the stated principles, explain in detail the content of the non-financial information report with illustrative examples for each item.
The awareness of climate-related reporting has increased significantly in recent years. The benefits of climate-related reporting for a company can be more fold, for example: a) emphasizing awareness of climate-related risks and willingness to manage them, b) due to the focus on sustainability, lower cost of capital, improved creditworthiness and greater attractiveness of the company for attracting new investors can be expected, and c) better corporate reputation, etc. A climate-related disclosures should be integrated for each of the five reporting areas listed in the NFRD: "(a) business model, (b) policies and due diligence, (c) outcome of policies, (d) principal risks and risk management, and (e) key performance indicators". The guidelines of the NFCD should be applied to all non-financial reporting entities, regardless of their sector of activity. At the same time, the *Action Plan on Financing Sustainable Growth* especially emphasizes “the importance of the financial sector in enabling the transition to a low-carbon and climate-resistant economy”. In fact, banks and insurance companies can have a negative impact on the risks of climate change if they finance or insure economic activities that contribute to pollutant emissions or cause environmental degradation in general. Moreover, they can promote the transition to a low-carbon and climate-resilient economy and raise awareness of the need for the environmental protection, not only in certain financing or insurance transactions, but also through transparent disclosure of financial and non-financial information related to their policies. Detailed guidance on all aspects of climate-related disclosure by banks and insurance companies can be found in the “Guidelines on non-financial reporting: Supplement on reporting climate-related information” (European Commission, 2019), which is why we will not highlight them in our paper.
Two years before the adoption of the above mentioned Guidelines, investors' growing demands for transparency regarding financial and non-financial information on climate-related risks, how they are identified and managed, have caused the issuance of recommendations of the Task Force on Climate-related Financial Disclosures (TCFD – a Working Group established by the G20’s Financial Stability Board) in 2017. The EU-Guidelines on reporting climate-related information integrate the TCFD recommendations taking into account the key requirements of the NFRD. However, there are some differences between these two sets of recommendations. For example, the TCFD proposes "publishing its recommended disclosures in the company’s annual financial filings”. On the other hand, according to the NFRD companies are permitted to publish their "non-financial statement in a separate report under certain conditions". Consequently, if a company subject to the NFRD wants to comply with the TCFD recommendations, its climate-related disclosures should be published in its management report. Furthermore, materiality in the NFRD concerns all three aspects of reporting - financial, environmental and social, while the TCFD considers only financial materiality.
In addition to the above analyzed the NFRD and the relevant guidelines from 2017 and 2019, it should be noted that at in late 2019 the European Parliament and the EU Council adopted the *Regulation on sustainability related disclosures in the financial services sector* 2019/2088 (European Parliament and the Council of the European Union, 2019), thereby providing additional guidance for non-financial reporting in this sector. Although “limited progress has been made in addressing climate-related financial disclosures” (Ernst & Young, 2020), and regulatory framework has already been set up, our opinion is that there is a room for further improvements. To meet requirements of investor and other stakeholders, the quantity, quality and comparability of published information should be higher. In addition, encouraging entities to disclose climate-related information would raise general awareness of the need to take care of climate change.

3. EU TAXONOMY FOR SUSTAINABLE ACTIVITIES: OPPORTUNITIES AND CHALLENGES

Reestablishing capital flows towards a more sustainable economy has been seen as one of the key ambition of the *EU Action plan for Sustainable Finance*, with the adaptation of the Taxonomy regulation as one of its key actions. Namely,

with the aim to fulfil the EU's climate and energy targets for 2030, and catalyzed by the COVID-19 pandemic that urged the need to make the economies and societies more resilient against environmental shocks, the EU needed a clear and common classification system for sustainable activities. This classification system is designed to be used by investors, companies and financial institutions while managing their environmental performances across a wide range of industries. The Taxonomy Regulation, published in the Official Journal of the European Union on 22 June 2020 and came into effect on 12 July 2020, is particularly focused on the environmental aspects of ESG. A phased implementation of the regulation is foreseen, with certain rules applying from different actors and dates. According to The Taxonomy (Article 3), as shown in Table 1, an investment can be regarded as sustainable as long as it:

- makes a substantive contribution to one of six environmental objectives,
- does not significant harm to the other five remaining objectives,
- meets minimum safeguards,
- complies with technical screening criteria.

According to the Taxonomy, climate change mitigation and adaptation are considered to be the two most important environmental objectives of the regulation. An economic activity can be qualified as helping substantially to climate change mitigation by contributing substantially to avoidance or reduction of greenhouse gas (GHG) emissions or the increase of GHG removals, including through process innovations or product innovations in line with the Paris Agreement goals. Such economic activities are, for example, those related to generating, storing, distributing or using renewable energy, improving energy efficiency, increasing clean or climate-neutral mobility, producing clean and efficient fuels from renewable or carbon-neutral sources, etc.

Table 1: The main elements of the sustainable activities according to the EU Taxonomy

Significant ccontribution to one or more of the environmental objectives
These objectives are: (a) climate change mitigation; (b) climate change adaptation; (c) the sustainable use and protection of water and marine resources; (d) the transition to a circular economy; (e) pollution prevention and control; (f) the protection and restoration of biodiversity and ecosystems. The Taxation recognizes: (a) activities that contribute themselves substantially to one of the six environmental objectives, (b) so called *enabling activities*, that facilitate other activities to make a substantial contribution to on or more of the objectives.
Without significant harming the other remaining environmental objectives
What is defined as significanty harm is specific for each of six entivormental objectives, and considers the life cycle of the products and services provided by an economic activity.
Adhere to minimum safeguards
The minimum safeguards refer to the OECD Guidelines on Multinational Enterprises, the UN Guiding Principles on Business and Human Rights, the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.
Complies with technical screening criteria
In order to be defined as „sustainable“ under the Taxonomy Regulation, each economic activitiy will be associated with a set of requirements that must be met. The technical screening criteria should be regularly review by the EU Commision and in line with scientific and technological developments.

Source: EU Taxonomy Regulation, 2020, authors` presentation

The Taxonomy Regulation can be voluntarily used by investors, companies and financial institutions, i.e. by any market participant inclined towards classifying its own economic activities as sustainable. However, there are two key groups of market participants for which the reporting under the Taxonomy will be mandatory: a) financial market participants offering financial products within the EU and the UK, and b) large public interest companies, i.e. the same pull of companies that are required to disclosure non-financial statements by the Non-Financial Reporting Directive. By providing non-financial information and increasing transparency, the Taxonomy is expected to reduce information asymmetry (Cho et al., 2013) and to result in lower costs of capital for companies with a higher share of Taxonomy-aligned activities (Zerbib, 2019). In addition, the Taxonomy can be regarded as a sort of international benchmark for other jurisdictions in their endeavors toward establishing their own taxonomies.

As it can be anticipated, the taxonomy is a first step to define in a comprehensive way and with consistency what is essentially meant by "sustainable activities". It has been regarded as a milestone of "green finance era", "the world's first-ever 'green-list', "the first green gold standard" or "the backbone of the sustainable finance". Yet, despite all the efforts aiming at correcting the inconsistency in terminology, eliminating green washing, and finally enabling the whole idea of sustainable finance and green economy feasible, the EU taxonomy is still not free from deficiencies and need to be a subject of further developments and improvements. The main weakness are related to the thematic and sectorial coverage and scope of the Taxonomy, its connection to the existing EU legislation in the area of green economy and reporting, as well as its one-dimensional approach, i.e. its focus alone on the environmental aspects of ESG.

The Taxonomy encompasses activities causing almost 80% of the EU GHG emissions (emissions-intensive sectors, such as air transport, manufacture of coke and refined petroleum, retail trade or mining, responsible for 12.4% of total emission, are not covered currently by Taxonomy), but only 20 percent of employment (Schütze & Stede, 2020). Considering that under the NFRD all companies with more than 500 employees are required to mandatory publish non-

financial information, adding taxonomy-related into NFRD requirements will have unintended effect: omission of some emission-intensive companies on one hand, while adding reporting efforts for companies with low emissions on the other hand. In order to prevent this, as pointed by Schütze and Stede (2020), "an additional metric based on emission-intensity could be added as a requirement for Taxonomy-related reporting under NFRD". Furthermore, there is a contradiction between the Taxonomy proposed by the TEG and the sustainability requirements of the existing legislation (such as, for example, EU's Renewable Energy Directive, European Commission (2018b). This will accordingly lead to confusion among companies and investors and cause a danger that most of the investments aiming at mitigating climate change will be left outside of the Taxonomy, and thus without 'green funding' (Neste, 2020). Additionally, the purpose of the taxonomy to reorient financial flows toward sustainable activities is supposed to be achieved by overpassing a financing gap (for all listed sustainable activities that are underfinanced). However, as observed in the practice (Eco-Business, 2020), the growth of numerous green activities is limited by factors other than finance (such as lack of consumer demand or unfavourable tax environment), and the channeling of finance flows toward all activities defined as "sustainable" may lead to risk of creating a "green bubble".

The Taxonomy seems to be too specific and too broad at the same time, with the uncompromising attitudes on some products, and the tolerance on others, leaving still space for green washing, as firms find opportunities for product "arbitrage" (Cognito, 2020). Moreover, the same sustainability sectors in need of investments into breakthrough technologies, even if the thresholds for Taxonomy-eligible activities can be used both for assessing the current performance of companies and as a screening tool for new investments, which poses a lot of challenges in screening and evaluation process. Finally, taking into account the focus on the environmental aspects of sustainability, the EU Commission uses one-dimensional approach ignoring two of the three sustainability dimensions with potentially damaging consequences. The Taxonomy is developed with the idea to provide policy incentives to promote sustainable investment. In order to answer it main purpose, it need to address two other important sustainability issues. In this regard, further development of the Taxonomy Regulation should be extended to include social and economic issues as well as a wider range of environmental factors.

4. CLIMATE RISK REPORTING REQURIMENTS FOR INSURANCE COMPANIES

The insurance industry is one of the largest global industries with more than USD 6 trillion in world premium volume and USD 36 trillion in assets under management (Swiss Re Institute, 2020). Insurers hold a significant portion of global economic assets and liabilities on their balance sheets. In its capacity as a risk manager, risk carrier and investor, the insurance sector can play a leadership role in building climate-resilient communities and in reaching the SDG. The insurance industry is primary level contributor to six SDGs and also a secondary level contributor to five other SDGs. Insurance exists to protect against the risk of uncertainty, including environmental, social and governance (ESG) risks. As such, insurers are in a position to promote sustainable action through the underwriting process, as well as in investment decisions (Geneva Association, 2018). Through its core actuarial function, the insurance sector is perhaps the most relevant part of the financial sector in understanding the pricing of climate risks. For over three decades, non-life insurers have invested in climate risk research, analysis and pricing, as part of their Nat Cat modelling. Furthermore, insurers have been instrumental in raising climate risk awareness, promoting risk reduction and preventive measures and innovating risk transfer solutions to build socio-economic resilience to physical climate risks in a changing climate (Stechemesser, et al., 2015).

Climate risk assessment and related disclosures are gaining momentum among insurance regulators and standard setting bodies such as the International Association of Insurance Supervisors (IAIS) together with the Sustainable Insurance Forum (SIF), the Network for Greening the Financial System (NGFS), the European Supervisory Authorities (ESAs), the European Insurance and Occupational Pension Authorities (EIOPA), the National Association of Insurance Commissioners (NAIC) (Financial Stability Board., 2017; Ahlström and Monciardini, 2021). Public disclosure of material information (which includes climate-related risks) is expected to enhance market discipline by providing meaningful and useful information to policyholders to make decisions on insuring risks with the insurer, to market participants to make decisions about providing resources to an insurer, and to facilitate comparisons between insurers.

Within the EU legal framework, as stated before, disclosure obligations on ESG which may be relevant for insurance companies are set out in: 1) Non-Financial Reporting Directive, 2) Disclosure Regulation and 3) Taxonomy Regulation. All three legal acts play an important role in the transparency of sustainable investment, especially in relation to the elimination of "greenwashing" and the increase of market awareness on sustainability matters. With regards to ESG aspects, the NFRD and the Disclosure Regulation contain extensive disclosure obligations on all three components of ESG, whereas the disclosure obligations in the Taxonomy Regulation mainly cover environmental aspects. The Disclosure Regulation, directly applicable in all EU Member States from March 10, 2021, contains disclosure regulations with regard to: a) the integration of sustainability risks, b) the consideration of adverse sustainability impacts in the processes of the financial market participants and financial advisers and, c) the provision of sustainability-related information with respect to financial products.

The Disclosure Regulation contains a number of different disclosure obligations, including the duty to publish adverse sustainability impacts of investment decisions/investment advice on sustainability factors on the website and the manner in which sustainability risks are integrated into investment decisions/investment or insurance advice in pre-contractual

disclosures. Insurance market participants have to disclose in pre-contractual disclosures and periodic reports: a) information on the environmental objective(s) to which the investment underlying the financial product contributes, and b) a description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable, including the proportion of underlying investments that are Taxonomy Regulation-aligned. The same applies to insurance products that promote environmental characteristics. For insurance products that do not invest in environmentally sustainable activities, a disclaimer stating that the relevant investments "do not take into account the EU criteria for environmentally sustainable investments" has to be included.

Despite these initiatives, there are still challenges in monitoring and mitigating climate-related risks in both underwriting and investment activities. The industry still lacks a standardized reporting on green investments, emission metrics and climate impact of exposures which would help to enhance the use of scenario analysis in risk modelling and portfolio management. The establishment of the taxonomy has encountered some critics related to the rigidity of administrative procedures to decide which activities are included in the official classification as well as the lobbying and political pressure that could influence such decisions. Some researchers argue that a market-led approach could be more suitable in view of the dynamism in the field of sustainable finance, e.g. (Schoenmaker, 2018). Other critics highlight that the taxonomy follows a binary approach that neither takes into account the 'shades of green' nor the context and consequently, it would not provide the necessary incentives for investors (Caldecott, 2019). The insurance industry has also warned that a too narrow taxonomy, covering a very small portion of the companies in the investors' portfolio, would have a limited value (Insurance Europe, 2019). It has also been highlighted that the taxonomy is a useful tool for the integration of environmental, social and governance (ESG) factors in investment decisions, however regulatory pressure should be avoided to invest into assets just because they are in scope of the taxonomy.

5. CONCLUSION

In response to climate related risks, the EU established several targets and actions through a combination of financial support and regulation within the EU climate action. This initiative includes packages with sets of binding legislations with climate and energy targets to be achieved to the long-term goal of transforming the EU economy towards low carbon utilization by 2050. Climate risk reporting is part of reform actions and an increasingly important public policy issue of concern to the financial service sector. However, while increasing regulatory and political scrutiny has recently raised public awareness of the importance of the climate-related reporting requirements, there is little prior systematic research on this issue related to these sectors. This paper contributes to the existing literature by providing evidence on current legislative reporting requirements related to the climate-risk exposures of the financial institutions at European Union level. A special focus was given to the insurance industry because of its high potential to incorporate climate-related risks in the underwriting and investment activities as part of an approach towards ESG factors. Climate risk disclosures initiatives for the insurance industry gain in importance and are prescribed in the NFRD, Disclosure Regulation and Taxonomy Regulation. However, there are still challenges such as the need for standardized reporting, the rigidity of administrative procedures, the binary approach, the taxonomy narrowing and possible regulatory pressure on the investment decision process in the insurance companies.

In terms of future research and policy recommendations, we identify at least three key elements. First, in order to foster sustainable growth and to channel funding in economic activities enabling and contributing to ESG related objectives, it is to improving data availability and therewith the public disclosure of relevant metrics by reporting entities. Second, there is a strong investor demand for non-financial reporting, providing important insights into sustainability risks and opportunities, for example regarding the impact of climate change on business models of financial institutions as well as regarding the effects of economic activities on the environment and the society considering social aspects and human rights. Relevant sustainability reporting is expected to become a powerful tool to enhance the efficiency of capital markets and a risk-based allocation of financing. For that, non-financial reporting has to become a reliable, standardized and transparent addition to financial statements. To enable trust in sustainability reporting, it is necessary that the basis of such reporting is clearly defined, and the reported figures are comparable across countries and industries. Therefore, of the ultimate importance is the support of the IFRS Foundation's initiative to consider the potential for globally accepted sustainable reporting standards to promote internationally consistent and comparable non-financial reporting. Finally, this paper could contribute in the regional scale among the western Balkan countries to take the advantage of existing international initiatives to build a high-quality set of recognized non-financial reporting standards and to raise the awareness of the importance of the climate - related actions.

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