EU Sustainable Finance Regulation

Enhancing and simplifying to enable the transition

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Contents

Contents 1
Executive Summary 2
List of Recommendations 3
Introduction 5
Recommendation 1: Simplify the EU Taxonomy to make it more usable for a broader audience 6
Recommendation 2: Reform SFDR and also position transition finance more centrally 8
Recommendation 3: Enhance the usability of the EU Climate Transition Benchmarks (CTB) and EU Paris Aligned Benchmarks (PABs) 11
Recommendation 4: Align reporting standards for corporate transition plans globally 14
Recommendation 5: Achieve globally consistent corporate emissions data, including Scope 3 emissions 15
Achieve climate leadership and transparency at the sovereign level through national transition plans 17

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*EU High Level Group on Sustainable Finance (2016-2018)

Executive Summary

The European Union (EU) is a global leader in sustainable finance. It has developed a comprehensive policy and regulatory framework to better integrate sustainability and climate priorities into the financial system to steer capital towards activities that support the transition to a low-carbon, sustainable economy. The EU sustainable finance framework has been unique in its holistic approach and has inspired many other jurisdictions to develop their sustainable finance and taxonomy regulations.

As this framework is being implemented, it is becoming apparent that the complexity and detail of the regulations could be a barrier to scaling adoption and impact. On November 8, the Budapest Declaration on the New European Competitiveness Deal set out a planned "simplification revolution" to reduce reporting requirements "by at least 25%" as part of the plan for Europe's sustainable prosperity and competitiveness[1]. This reflects a broader acknowledgement of the need to review the EU framework and represents a critical opportunity to streamline the regulatory framework, making it more scalable and usable by the financial sector and the corporate community.

Simplifying the EU sustainable finance framework would enhance European competitiveness by reducing compliance complexity, fostering innovation, and enabling businesses to allocate resources more effectively toward sustainable growth. Simplified requirements would also encourage broader participation from businesses and investors, including those outside the EU, to finance the transition and support the ambitions of the EU Green Deal[2]. This approach would foster a more inclusive and efficient environment for achieving sustainability goals.

With its position at the intersection of global markets and businesses, LSEG is deeply involved in the European financial ecosystem. This policy paper proposes a set of pragmatic suggestions to simplify and enhance the usability of the EU's sustainable finance framework – with a particular focus on transition finance[3]. While the CSRD is a critical component of the EU's policy framework, this paper does not include recommendations specifically related to that Directive.

An overriding principle throughout these recommendations is the objective of working steadily towards a greater level of global consistency to reduce cost burdens and to enable capital markets to work efficiently. The ideal outcome is full alignment, but on a pragmatic basis clear and well designed “interoperability” between standards can be a first phase. Over time standards should evolve to become increasingly aligned, as has been the case for financial reporting. In particular, the use of XBRL – that makes data easier to collect, share, and analyse – should enhance interoperability between standards. It will enable investors to compare financial data across companies in all jurisdictions more efficiently and could help provide clarity and a roadmap for the changes required to increasingly align standards.

The recommendations here are not intended to be fully comprehensive but a starting point for further engagement and discussion.

LSEG’s recommendations focus on making improvements in five areas of policy making to better achieve the EU’s stated aim to support the transition to a low carbon, sustainable economy:

1. Simplify the EU Taxonomy to make it more usable to a broader audience
2. Reform the Sustainable Finance Disclosure Regulation (SFDR) and position transition finance more centrally
3. Enhance the usability of the EU Climate Transition and EU Paris Aligned Benchmarks
4. Align reporting standards for corporate transition plans globally
5. Achieve globally consistent corporate emissions data, including Scope 3 emissions

In addition, this paper encourages action by individual countries to achieve climate leadership and transparency at the sovereign level.

[1] Budapest Declaration on the New European Competitiveness Deal - Consilium

[2] Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: The European Green Deal, COM (2019) 640 final.

[3] As defined by the European Commission in its Recommendation (EU) 2023/1425 on facilitating finance for the transition to a sustainable economy.

List of Recommendations

1. Simplify the EU Taxonomy to make it more usable for a broader audience

1.1 Without undermining the core aims of the EU Taxonomy, LSEG recommends (i) removing the most ambiguous technical screen criteria (TSC), (ii) reducing redundancy and subjective language and (iii) removing or addressing TSC where there is limited or no corporate disclosure.

1.2 To improve the consistency and reliability of reported information, LSEG recommends that companies are required to provide an explanation of how they calculate their taxonomy-based indicators including where relevant how they pass the streamlined TSC.

1.3 To increase the interoperability of the EU Taxonomy, LSEG recommends working with the International Sustainability Standards Board (ISSB), the International Platform on Sustainable Finance (IPSF), the International Organization of Securities Commissions (IOSCO) and other global actors to develop a single global sustainability reporting standard for taxonomies.

2. Reform SFDR and also position transition finance more centrally

2.1 LSEG recommends increasing transparency on estimated data used by financial market participants in Principal Adverse Impacts (PAI) indicators and allow investors to use equivalent data for reporting purposes.

2.2 LSEG recommends the creation of a clear ESG funds' categorisation system that meets the following principles:

- i. Minimum criteria for each category should be (a) simple, (b) tested by the industry, commonly accepted, and (c) sufficiently flexible to suit all types of ESG investment strategies.
- ii. Minimum criteria should be fit-for-purpose for both active and passive investment strategies and be agnostic in terms of financial instruments.
- iii. Some flexibility in terms of KPIs/metrics to use should be left to asset managers as the most relevant KPIs are likely to depend on the specific sustainability objectives for each product.
- iv. Add a climate transition fund category (i) that supports a variety of decarbonation strategies and (ii) whose minimum criteria do not lead to the exclusion of high-emitting companies, provided they have a credible transition plan.
- v. Terminology, definitions and principles should be closely internationally aligned and considered in light of the regulatory developments made or underway by other jurisdictions, including SDR in the UK, to avoid practical issues, fragmentation and confusion for financial institutions and investors operating globally.

2.3 LSEG recommends introducing machine readability in SFDR and European ESG Template (EET) reporting to increase the comparability of sustainability information and help minimise costs of data collection.

3. Enhance the usability of the EU Climate Transition and EU Paris Aligned Benchmarks

3.1 LSEG recommends reviewing the approach to Scope 3 data to align with expected improvements in corporate emissions reporting over time including the gradual implementation of the Corporate Sustainability Reporting Directive (CSRD).

3.2 LSEG recommends re-assessing the portfolio decarbonisation methodologies to focus on forward-looking information based on transition plans and targets, which can also be used by investors in their corporate engagement.

3.3 LSEG recommends reviewing the carbon intensity metric and consider alternative measurement approaches.

3.4 It is key to review the "Paris Aligned Index" blanket industry exclusions, as well as how to consider these issues for emerging markets. It is also important to take on board international work on climate and climate transition indexes when reviewing this whole area.

4. Align reporting standards for corporate transition plans globally

4.1 LSEG recommends the European Financial Reporting Advisory Group (EFRAG) to work with the ISSB to achieve global consistency through a two-step process:

i. Enhance the Transition Plan Taskforce (TPT) - European Sustainability Reporting Standards (ESRS) mapping document to clearly outline the commonalities and differences between the two frameworks.

ii. Establish a clear timeframe and path towards increasing global alignment of transition plan frameworks, involving ISSB and IOSCO to ensure international standardisation of practices.

4.2 LSEG recommends the European Commission and EFRAG to collaborate with IOSCO, ISSB and the Global Reporting Initiative (GRI), working with relevant industries, to agree sector-specific disclosures within transition plans that include mandatory metrics and use cases. These plans should be grounded in commonly accepted global standards to ensure consistency and usability for investors.

5. Achieve globally consistent corporate emissions data, including Scope 3 emissions

5.1 LSEG recommends EFRAG and the European Commission take forward work to set clear sector-specific guidance on the most material Scope 3 emissions categories in close partnership with the ISSB and GRI using the GHG Protocol Corporate Standard.

Additionally, LSEG also encourages EU Member States to achieve climate leadership and transparency through national transition plans

LSEG encourages EU countries to strengthen the detail contained in their national energy and climate plans (NECPs) to provide the underlying goals and sub-level targets that underpin their nationally determined contributions (NDCs) and set out their adaptation plans in relation to the physical impacts of climate change.

While we acknowledge that the European Commission monitors progress biannually, LSEG encourages EU institutions to establish a mechanism to monitor and report the progress of Member States in delivering their NDCs on a yearly basis. This would provide businesses and finance sector the confidence to set their own net zero plans and targets, and it enables institutional investors who have sovereign bond portfolios to better assess sovereign climate risks and allocate capital.

LSEG also encourages EU institutions to add practical guidance to improve the comparability and comprehensiveness of national transition and adaptation strategies including quantifiable information. An additional opportunity to explore is making available detailed national level emissions data and the data that is collected for CBAM for usage by companies in their reporting processes.

Introduction

The European Union (EU) is a global leader in sustainable finance. It has developed a comprehensive policy and regulatory framework to better integrate sustainability and climate priorities into the financial system with the aim of steering capital towards activities that support the transition to a low-carbon, sustainable economy.

The EU's approach to sustainable finance has been developed in a systematic manner over several years. It started in 2016 with the European Commission establishing a High-Level Expert Group (HLEG) on sustainable finance to comprehensively map out the challenges in the system and options to address them.

Following the HLEG report and recommendations, the EU developed its Sustainable Finance Action Plan launched in 2018 and formed a successor to the HLEG, the Technical Expert Group (TEG) on Sustainable Finance. The TEG worked alongside the European Commission to support the implementation of the plan into technical specifications to feed into the regulatory instruments being developed. LSEG is proud to have contributed experts to both groups and continue to be involved, for example as a member of the Sustainability Reporting Technical Expert Group (EFRAG SR TEG).

The quality of the sustainable finance framework lies in the collaborative efforts between the European Commission, European and national regulators, the private sector, academics and NGOs through various working groups and, more recently, the Platform on Sustainable Finance. Ensuring that stakeholder perspectives continue to be considered beyond these formal structures remains also important.

The EU's sustainable finance action plan sets out ten key actions divided across three areas:

1. reorienting capital flows
2. mainstreaming sustainability risk management
3. fostering transparency and long-termism

This represented the first truly comprehensive approach to deeply connect sustainability and the financial system and amongst other interventions led to the EU Taxonomy, the Corporate Sustainability Reporting Directive (CSRD), the transparency of ESG ratings and the Sustainable Finance Disclosure Regulation (SFDR), setting guidelines for companies and investors to measure and report sustainability performance. In 2020 after the TEG completed its work the EU set up its Platform on Sustainable Finance to guide the work of the EU Taxonomy and on green finance policy development.

The European Commission's sustainable finance framework is unique in this holistic approach and has inspired several other jurisdictions to develop their own taxonomies and sustainable finance disclosure regulations. In our last annual survey[4], 90% of asset owners acknowledged that ESG regulations have helped them to meet their sustainable investment goals. This has improved significantly the previous year, indicating that over time asset owners have taken a more positive view of ESG regulations.

As the sustainable finance market has rapidly evolved, this regulatory environment could create burdens and differences in interpretation that could increase compliance costs for market participants and greenwashing risks. This complexity could hamper efforts to move capital at scale to address sustainability challenges.

There is an opportunity for a combination of enhancements and simplifications of the EU regulatory framework to ease usage. This would enable deeper and more scalable application into investment strategies and help support progress towards the EU's ambitious climate goals of the Green Deal.[5] This could support long term economic growth both in the EU and globally.[6]

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[4] FTSE (2024), Sustainable Investment: 2024 global survey findings from asset owners.

[5] Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: The European Green Deal, COM (2019) 640 final.

[6] The green economy represents a generational investment opportunity. LSEG data shows that the global green economy, in terms of size, growth trajectory, and financial performance, is one of the most significant investment opportunities of the 21st century. LSEG (2024), Investing in the green economy.

Recommendation 1: Simplify the EU Taxonomy to make it more usable for a broader audience

The EU has pioneered the development of a comprehensive framework for sustainable finance, with the Taxonomy as its core. The Taxonomy guides capital towards environmentally sustainable activities and supports the transition to a low-carbon economy. It also influences companies in developing their business strategies, transition plans, and target setting.

Companies have started using the EU Taxonomy to guide and showcase their taxonomy-aligned capital investments, with 600 European companies reporting taxonomy-aligned capital investment of €191 billion in 2023, rising to €249 billion in 2024.[7] Financial institutions, including banks and investors, have also adopted the EU Taxonomy to compare companies' transition efforts and structure sustainable financial products such as green bonds and sustainability-linked loans.

Despite this important progress, market participants continue to face challenges such as data collection, complex application criteria, and the lack of consistency in reporting practices.[8] These challenges make it difficult for investors to allocate assets effectively. In a recent survey, 76% of the respondents stated that they cannot use the EU Taxonomy to make investment decisions.[9] To unlock its full potential, the EU Taxonomy should be simplified.

Enhance the usability of technical screening criteria

Based on three delegated acts adopted between 2021 and 2023, the EU Taxonomy established over 500 Technical Screening Criteria (TSCs)[10] identifying 152 economic activities which make a Substantial Contribution to an environmental objective, Do No Significant Harm (DNSH) to the environment and meet Minimum Social Safeguards. An activity is considered aligned with the Taxonomy – i.e. it provides a credible low carbon climate or environmental solution – if it meets all these criteria. The aim of the TSC of the Taxonomy is to provide clear, science-based thresholds to determine whether economic activities substantially contribute to environmental objectives, supporting alignment with the EU's climate and sustainability goals.

Based on the data we have collected, we calculate that the Taxonomy's complexity limits the investible universe to less than 1% of global listed equity markets, although simplified TSC could expand this to 8%,[11] which would make it more relevant for institutional investors to then consider in asset allocation.

When analysing the full spectrum of TSC[12], LSEG has identified 525 criteria – 322 related to Substantial Contribution and 203 related to DNSH. LSEG has also observed that TSC are not evenly distributed across objectives or activities. Some economic activities are subject to far more criteria than others, and some environmental objectives also have many more than others. Given the number of TSC, reporting against the EU Taxonomy is a considerable task. TSC implementation requires extensive assessment and data, which makes it difficult to apply. Data is often not available or consistent with existing ESG standards and most companies do not disclose this information in their public reporting.

Many of these TSC are specific to EU legislation, which further complicates their application for global actors. For example, under the activity "Manufacture of Batteries", the DNSH requirements reference multiple pieces of EU legislation which are unlikely to ever be imposed outside of an EU context.

In addition to the number of TSC, the EU Platform recognises[13] that nuances and ambiguity within each criterion can make it challenging to assess the EU Taxonomy alignment of business activities and companies. To address these issues, LSEG recommends removing a significant volume of the ambiguous TSC, and reducing redundancy and subjective language. As a relevant example, the use of expressions such as "substantially reduce" or "is minimised" in the description of the criteria does not clearly indicate to what extent measures to avoid or minimise risk and harm are expected.

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[7] European Commission (2023), Factsheet: The EU Taxonomy's uptake on the ground.

[8] As identified by the Platform on Sustainable Finance in its Compendium of Market Practices published in January 2024.

[9] https://www.dai.de/en/detail/companies-esg-transformation-or-just-reporting

[10] Technical screening criteria encompass substantial contribution and do no significant harm (DNSH).

[11] "Do No Significant Harm" and "Minimum Safeguards" in Practice - Navigating the EU Taxonomy Regulation (lseg.com)

[12] Details on the LSEG analysis of TSC "Do No Significant Harm" and "Minimum Safeguards" in Practice - Navigating the EU Taxonomy Regulation (lseg.com)

[13] Platform on Sustainable Finance, (2024). Platform on Sustainable Finance report on a compendium of market practices.

Enhance transparency on how companies pass technical screening criteria and calculate their taxonomy-aligned indicators

The EU sustainable finance framework aims to improve transparency in corporate reporting. However, challenges in applying the EU Taxonomy are leading to inconsistent interpretations and varied corporate disclosures.

Some companies report no alignment to the EU Taxonomy, awaiting further regulatory guidance. Others provide partial compliance based on DNSH criteria. LSEG data indicates that these differences are driving a wide range of reported eligible or aligned revenues and capex. Often, this variation reflects disparities in disclosure practices rather than actual differences in the environmental sustainability of products or business models. This can also create the perception of greenwashing in corporate reporting.

To increase EU Taxonomy usability, companies should disclose how their activities meet the TSC in addition to reporting taxonomy-aligned indicators like revenues and capex. Currently, few companies provide this detailed information, often just stating a binary "Yes/No" alignment of their activities. Whilst this would constitute an additional reporting task for companies, simple reporting on criteria used to qualify their alignment would provide greater, and necessary, insight to investors that would make the entire framework more efficient.

Increase the interoperability of the EU Taxonomy

One of the concerns from global investors and from companies operating across multiple countries is the proliferation of national and regional taxonomies which are all different. To apply the EU Taxonomy to global portfolios, non-EU entities will need to report equivalent data. A common global standard to allow fungibility is needed. This would involve practical guidance and discussions with the International Financial Reporting Standards Foundation (IFRS), International Organization of Securities Commissions (IOSCO) and the International Platform on Sustainable Finance (IPSF).

Recommendation 1: Simplify the EU Taxonomy to make it more usable for a broader audience

1.1 Without undermining the core aims of the taxonomy, LSEG recommends (i) removing the most ambiguous technical screen criteria (TSC), (ii) reducing redundancy and subjective language and (iii) removing or addressing TSC where there is limited or no corporate disclosure.

1.2 To improve the consistency and reliability of reported information, LSEG recommends that companies are required to provide an explanation of how they calculate their taxonomy-based indicators including where relevant how they pass the streamlined TSC.

1.3 To increase the interoperability of the EU Taxonomy, LSEG recommends working with ISSB, IPSF, IOSCO and other global actors to develop a single global sustainability reporting standard for taxonomies.

Key references and sources:

- LSEG, Dai et al (2021). Do No Significant Harm" and "Minimum Safeguards" in Practice - Navigating the EU Taxonomy Regulation, available at: https://www.lseg.com/content/dam/ftse-russell/en_us/documents/research/navigating-eu-taxonomy-regulation.pdf
- LSEG, Dai et al (2024). Reality check: 8 years after the first EU Taxonomy conversation, available at: https://www.lseg.com/en/insights/reality-check-8-years-after-first-eu-taxonomy-conversation
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- European Commission, (2023). Enhancing the usability of the EU Taxonomy and the overall EU sustainable finance framework.
- European Commission, (2023). Factsheet: The EU Taxonomy's uptake on the ground.

Recommendation 2: Reform SFDR and also position transition finance more centrally

The Sustainable Finance Disclosure Regulation (SFDR) has been instrumental in promoting transparency and disclosure within the investment community, enabling investors to better understand the sustainability profile of investment products.

But some challenges remain, including unclear fund categories and limited data for reporting adverse impacts. Addressing these issues can help achieve the SFDR's original objectives more effectively[14]. Reforming the SFDR is a valuable opportunity to enhance the EU's sustainable investment framework and place transition finance at its core. The future SFDR should recognise diverse approaches to support the necessary broad adoption of transition finance.

Furthermore, the review of SFDR should also consider the current market structure of the investment sector in the EU, which is heavily dominated by wholesale investors, compared to retail. Indeed, as of 2022, the share of institutional clients compared to retail clients in total assets under management in the EU stood at 70%[15] (a number that has been steady for at least the past decade).

Align SFDR PAI reporting with CSRD's approach of materiality

While CSRD is expected to provide investors with more data in the coming years, it may substantially enhance asset managers' reporting of principal adverse impact indicators (PAI). The SFDR PAI reporting rule does not consider materiality: all investment managers must report on all PAI indicators. In contrast, under CSRD, corporates only need report on indicators that are either financially material to them, or have a material sustainability impact. This discrepancy means data gaps will persist for non-material indicators not reported by companies but still required under SFDR.

To address this, aligning the materiality approach of SFDR with CSRD is essential to ensure that SFDR disclosures focus on material PAI indicators that companies report.

Increase transparency on estimated data used for PAI indicators and allow investors to use equivalent data

It is often challenging to understand the source and degree of reliability of the data used for the calculation of PAI indicators by financial market participants (FMPs). To enhance transparency for end-clients and boost confidence in sustainability-related products, more detailed information should be required on how FMPs handle missing or non-available data. In line with ESMA's best practices,[16] for each PAI indicator, FMPs should indicate the proportion of data that is reported by investee companies and the proportion of data that is estimated.

When needed to report on companies in the portfolio that are not subject to CSRD, FMPs typically rely on estimated data, which can vary widely, and may be based on simplistic assumptions or broad sectoral inferences. To improve data reliability, the European Commission should provide guidance and allow the use of ESG indicators based on global standards that are publicly reported by companies and considered equivalent to the PAI indicators in Annex I of SFDR, as long as the differences are minimal.

Create ESG funds categories that are suitable for all types of investment strategies

To avoid confusion, EU institutions should create clear ESG funds' categories that meet the following principles:

i. Define simple, tested by the industry and commonly accepted, and sufficiently flexible minimum criteria for each fund category to suit all types of sustainable investment strategies. It is also important to consider the needs of institutional investors, in addition or in parallel to retail clients, when designing new sustainability categories, given wholesale investors' central role in capital markets and, consequently, in funding the transition.

ii. The minimum criteria should be suitable for both active and passive investment strategies. Our research[17] shows that an equal number (73%) of asset owners are implementing passive and active sustainable investment strategies, demonstrating the growing importance of the passive industry in the sustainable investment space. Therefore, LSEG

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[14] ESAs, Opinion on the assessment of the Sustainable Finance Disclosure Regulation (SFDR).

[15] European assets market: institutional & retail clients 2022 | Statista

[16] ESMA, Concept of estimates across the EU Sustainable Finance framework, 2023.

[17] Sustainable investment asset owner survey 2024 | LSEG

strongly recommends considering portfolio-level approaches alongside asset-specific ones and providing the ability to adapt the minimum criteria (in particular exclusion criteria) to ensure these strategies are effective.

iii. EU institutions should not be prescriptive in terms of KPIs to use. This flexibility should be granted to firms that are best placed to determine the methodology they use to measure progress towards their objectives. Regulation should focus on transparency, ensuring that the users can understand the chosen metrics and assess them. Firms should be allowed to use globally recognised, science-based standards. Otherwise, market innovation and the adoption of the latest approaches for measuring sustainability performance may be hindered.

iv. Create a climate transition category that supports a variety of decarbonisation strategies. It is essential to ensure that minimum criteria do not lead to the exclusion of high-emitting companies, provided that they have credible transition plans. As mentioned by the Platform on Sustainable Finance[18], a “credible transition strategy can also be set on portfolio level” to allow all types of passive investment strategies (e.g. tilting methodologies). The transition fund product should demonstrate how its investment strategy contributes to real economy decarbonisation over time, using clear and measurable criteria, leveraging EU initiatives like the EU Taxonomy, engagement disclosures under the Shareholder Rights Directive and existing global initiatives[19], such as CA100+ and TPI.

v. Terminology, definitions and principles should be closely internationally aligned. All these principles should be considered in light of the regulatory developments made or underway in other jurisdictions, including SDR in the UK, to avoid practical issues, fragmentation and confusion for financial institutions and investors operating globally.

Introduce machine readability

Introducing machine readability in SFDR and European ESG Template (EET) reporting will significantly increase the comparability of sustainability information and reduced data collection costs, making it easier to market sustainability funds. XBRL is one of the most effective automation tools, achieving high success rates at both document and data levels. While some countries are more advanced than others, XBRL has proven to be stable, with no major issues with data extraction.

Recommendation 2: Reform SFDR and position transition finance more centrally

2.1 LSEG recommends increasing transparency on estimated data used in Principal Adverse Impacts (PAI) indicators and allow investors to use equivalent data for reporting purposes

2.2 LSEG also recommends the creation of a clear ESG funds’ categorisation system that meets the following principles:

i. Minimum criteria for each category should be (a) simple, (b) tested by the industry and commonly accepted, and (c) sufficiently flexible to suit all types of ESG investment strategies.

ii. Minimum criteria should be fit-for-purpose for both active and passive investment strategies, and be agnostic in terms of financial instruments.

iii. Some flexibility in terms of KPIs/metrics to use should be left to asset managers as the most relevant KPIs are likely to depend on the specific sustainability objectives for each product.

iv. Add a climate transition fund category that (i) supports a variety of decarbonation strategies and (ii) whose minimum. criteria do not lead to the exclusion of high-emitting companies, provided they have a credible transition plan.

v. Terminology, definitions and principles should be closely internationally aligned and considered in light of the regulatory developments made or underway by other jurisdictions, including SDR in the UK, to avoid practical issues, fragmentation and confusion for financial institutions and investors operating globally.

2.3 LSEG recommends introducing machine readability in SFDR and EET to increase the comparability of sustainability information and help minimise costs of data collection.

[18] Platform on Sustainable Finance (2024), Categorisation of Products under the SFDR: Proposal of the Platform on Sustainable Finance, available at Categorisation of products under the SFDR: Proposal of the Platform on Sustainable Finance

[19] The Transition Finance Market Review provides an assessment of the literature available: Scaling transition finance | Findings of the Transition Finance Market Review

Key references and sources:

- LSEG, (2024). SFDR: LSEG Data & Analytics mapping of Level 2 Principal Adverse Impact (PAI) indicators, available at: https://www.lseg.com/content/dam/data-analytics/en_us/documents/fact-sheets/sfdr-principle-adverse-impact-indicator-coverage.pdf
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- ESMA (2023). Concept of estimates across the EU Sustainable Finance framework.
- Climate Action 100+ https://www.climateaction100.org/
- Transition Pathway Initiative https://www.transitionpathwayinitiative.org/

Recommendation 3: Enhance the usability of the EU Climate Transition Benchmarks (CTB) and EU Paris Aligned Benchmarks (PABs)

To create reliable climate indices meeting robust standards, the EU has created two labels: the EU Climate Transition Benchmarks (CTBs) and the EU Paris-Aligned Benchmarks (PABs). The Platform on Sustainable Finance (PSF) has also recently proposed two new voluntary labels Investing in Transition Benchmarks (ITBs) with Taxonomy-aligned Capital expenditure (CapEx) requirements.[20]

Index providers have developed PABs and CTBs to provide solutions for investors interested in aligning with the EU Benchmark Regulation minimum requirements which include a decarbonisation pathway. These labels have contributed to raise awareness and usage of decarbonisation trajectories in index design. In 2023, assets under management of financial products referencing a PAB or CTB benchmark reached an estimated EUR 180 billion by the end of 2024.[21]

FTSE Russell, an LSEG business, created its first EU PAB in 2020 and launched its wider series in partnership with Brunel Pension Partnership in 2021. In creating and maintaining these indices, significant challenges have been identified and we propose four recommendations to address each of them.

Align Scope 3 emissions requirements with the gradual implementation of the CSRD

Typically, Scope 3 carbon emissions data accounts for around 80% of a company's carbon footprint but is poorly reported, volatile and companies often restate historical data. Please see Recommendation 5 below and our research paper called "Scope for Improvement: Solving the Scope 3 conundrum". This raises questions on how best to manage Scope 3 carbon emissions risk from an index construction perspective.

To address these issues, we recommend a review on how Scope 3 data and risk is assessed and managed in EU CTB/PABs to better align with improvements in corporate emissions reporting, including the gradual implementation of the Corporate Sustainability Reporting Directive (CSRD) which will over time improve the availability and quality of corporate reported data.

The economy is not decarbonising at 7% year-on-year and there is an opportunity to make more use of forward-looking information such as corporate targets/transition plans

The global economy is not decarbonising at the 7% year-on-year decarbonisation rate required in the EU Benchmark Regulation. Between 2016 and 2022, the weighted average carbon intensity (WACI) of the FTSE All-World equity index has declined by 4.1% annually on a revenue basis and 5.1% on an ownership basis (enterprise value including cash or EVIC). However, the intensity has only come down because the increases in emissions have been lower than the increases in revenues and enterprise values. Chained absolute emissions[22] have in fact steadily risen by 2.3% per year for the FTSE All-World equity index over that period.

This is a risk for index users, as CTB/PABs will increasingly diverge from the underlying universe over time and become increasingly concentrated (i.e. fewer companies will qualify for index inclusion). This is a particularly acute risk for some sector or country specific indices, and emerging market indices. Further, for developing markets there is a need to consider how to reflect a more gradual decarbonisation rate. The new ITBs proposed by the Platform on Sustainable Finance might start off less constrained as the initial decarbonisation rate of 50% (PABs) and 30% (CTBs) would not apply. However, over time this concentration risk may become a challenge for them too.

There is also a risk that re-weighting investment universes by only looking at carbon intensity reduction would not result in real economy decarbonisation benefits. Therefore, we encourage a review of the decarbonisation rules. This should include a consideration of forward-looking information such as whether companies, particularly those from higher carbon industries, have set credible science-based targets over the short, medium and long term that are aligned with a global 1.5°C or 2°C trajectory. This information can also be used by investors using the index to engage investee companies, so they understand how their transition plans influence their inclusion and weights in the index as well as in associated index tracking portfolios.

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[20] Platform on Sustainable Finance report on investing for transition benchmarks (ITB)

[21] EU Platform on Sustainable Finance (2024), Investing for Transition Benchmarks (ITBs) Report.

[22] See page 6 on Figure 1 for explanation of Chained Emissions: https://www.lseg.com/content/dam/lseg/en_us/documents/sustainability/lsegdecarbonisation-portfolio-benchmarks-report.pdf

Review portfolio emissions metrics

EU Benchmark Regulation requires the use of Enterprise Value Including Cash (EVIC) as a normalisation factor for CTB/PABs. Alternative measures include revenues or market capitalisation as the denominator. LSEG analysis shows that short-term volatility in portfolio emissions performance is driven by non-carbon factors, including adjustments to normalisation factors such as EVIC.

There are a number of different ways to quantitatively measure portfolio decarbonisation and each measure in isolation can provide a very different perspective. More analysis on this can be found in our research report Decarbonisation in portfolio benchmarks: Tracking portfolio carbon transition[23]. LSEG recommends that investors view portfolio decarbonisation through a multi-variable lens, which allows for a more nuanced consideration of decarbonisation, while focused on multi-year trends rather than year-on-year fluctuations. We suggest that this approach is also considered as part of a review of CTB/PAB methodologies.

Ensure that high emitting sectors can be included in PABs

PABs require a range of industry exclusions to be applied which covers companies which have more than 1% of revenue from coal, more than 10% from oil and gas, and power utilities that have a GHG intensity of more than 100 g CO_2 e/kWh, that in effect, is an exclusion on almost all power utilities globally. In addition, the methodology requires the overall weight of higher carbon industries must "be no less than the [underlying] benchmark". Consequently, the weight of other higher carbon sectors may need to be disproportionally increased to counteract the exclusions and meet this rule.

This exclusionary methodology does not provide incentives for the transition of high emitting sectors, where the capital is needed to enable transition and is particularly problematic for emerging markets which require longer time periods to decarbonise. The exclusion of coal power for developed markets may reflect the urgency for early retirement set out by the International Panel on Climate Change to move away from coal-based power. However, the other exclusions should be reviewed including the impact for emerging markets.

Take on board findings from relevant global initiatives

Very helpful principles were developed by the Net Zero Asset Owner Alliance who are the institutional end users of such indexes and steer large portions of their investment portfolios via benchmarks. The ten principles cover, among others, avoiding mechanical exclusions of high-emitting sectors and including forward-looking indicators as key input. In October 2024, GFANZ also opened a consultation on principles and guidance on climate transition indexes.

Recommendation 3: Enhance the usability of the EU Climate Transition Benchmarks (CTB) and EU Paris Aligned Benchmarks (PABs)

3.1 LSEG recommends reviewing the approach to Scope 3 data to align with expected improvements in corporate emissions reporting over time including the gradual implementation of the CSRD.

3.2 LSEG recommends re-assessing the portfolio decarbonisation methodologies to focus on forward-looking information based on transition plans and targets, which can also be used by investors in their corporate engagement.

3.3 LSEG also recommends reviewing the carbon intensity metric and consider alternative measurement approaches.

3.4 Finally, it is also key to review the "Paris Aligned Index" blanket industry exclusions, as well as how to consider these issues for emerging markets. It is also important to take on board international work on climate and climate transition indexes when reviewing this whole area.

[23] LSEG (2024) Decarbonisation in portfolio benchmarks: Tracking portfolio carbon transition, available at Decarbonisation in portfolio benchmarks: Tracking portfolio carbon transition | LSEG

Key references and sources:

- LSEG, Shemfe et al, (2024). Decarbonisation in portfolio benchmarks, available at: https://www.lseg.com/content/dam/lseg/en_us/documents/sustainability/lseg-decarbonisation-portfolio-benchmarks-report.pdf
- LSEG, Wang et al (2020). FTSE Russell study on EU Paris aligned benchmarks, available at: https://www.lseg.com/content/dam/ftse-russell/en_us/documents/research/ftse_russell_study_on_eu_parisaligned_benchmarks_final_0.pdf
- LSEG, Hamill & Wu (2023). A Paris-Aligned Corporate Bond Benchmark, available at: https://www.lseg.com/content/dam/ftserussell/en_us/documents/research/a_paris-aligned_corporate_bond_benchmark_5.pdf
- LSEG, Rocamora et al (2023); Deliberate decarbonisation: Measuring transition intent with TPI MQ scores, available at: https://www.lseg.com/content/dam/ftse-russell/en_us/documents/research/deliberate-decarbonisation-measuring-transitionintent-with-tpi-mq-scores.pdf
- EU Platform on Sustainable Finance (2024), Investing for Transition Benchmarks (ITBs) Report
- Net Zero Asset Owner Alliance (2022). Development and Uptake of Net-Zero Aligned Benchmarks: A call to action for asset owners and index providers
- GFANZ (2024). Consultation on Index Guidance to Support Real-Economy Decarbonisation.

Recommendation 4: Align reporting standards for corporate transition plans globally

As the concept of transition plans gains prominence globally, a multitude of frameworks and regulations are emerging from different regions and countries. This proliferation raises concerns over the coherence of definitions, scenarios and metrics. This lack of alignment creates costs for companies and barriers for investors to be able to effectively use and compare transition plans across jurisdictions. It also increases risk of greenwashing by creating confusion and inconsistency.

As the EFRAG and the European Commission are working on guidance for transition plans, and as ISSB formalises its guidance on transition plans, based on the work of the Transition Plan Taskforce (TPT), there is a window of opportunity to gain coherence between the EU and international developments. In parallel, the report on transition planning by the EU Platform on Sustainable Finance will also provide further recommendations on the coherence of transition planning across EU legislation.

Ensure interoperability between the EU framework and international frameworks

The guidance should take into account the specificities of the EU regulatory framework while ensuring strong interoperability with the main global frameworks. The TPT-ESRS Comparison provides a good foundation for global companies seeking to navigate the complexities of ESG reporting. This document should be expanded to help companies more easily identify differences and commonalities.

While an increasingly unified global standard remains the ultimate goal, this clarity at a very granular level would support the objective of facilitating transition, enabling investors to better engage with companies across frameworks and jurisdictions. Digital representations of corporate transition plans combined with ongoing corporate disclosures will provide the necessary components for analysis of these plans. Detailed digital XBRL tagging for transition plans would be a key component of this process. Together these measures would help reduce confusion from diverging guidance and practices, improving investment decisions.

Create EU sector-specific guidance built on global standards

Sector-specific guidance is key to complement the existing ESRS and forthcoming European Commission's guidance on transition plans. Sector-specific transition plans are a valuable tool for companies, providing clear frameworks to guide their sustainability efforts while enabling comparability within sectors for investors and stakeholders. This tailored approach would provide industries with the customised metrics and methodologies needed for effective, globally aligned transition plans. These plans should align with existing global standards, such as TPT and GFANZ, to avoid added cost and market confusion.

Recommendation 4: Global alignment of consistent and strategic transition plans

4.1 EFRAG should work with the ISSB to achieve globally consistency through a two-step process:

i. Enhance the TPT-ESRS mapping document to clearly outline the commonalities and differences between the two frameworks. Develop a collaborative approach for a core XBRL tagging model that can be used on a global basis.

ii. Establish a clear timeframe and path towards increasing global alignment of transition plan frameworks, involving ISSB and IOSCO to ensure international standardisation of practices.

4.2 The European Commission and EFRAG should also collaborate with IOSCO, ISSB and GRI, working with relevant industries, to agree sector-specific disclosures within transition plans that include mandatory metrics and use cases. These plans should be grounded in commonly accepted global standards to ensure consistency and usability for investors.

Key references and sources:

- IOSCO, Report on transition plans, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD772.pdf
- TPT Disclosure Framework – European Sustainability Reporting Standards, available at: https://www.ifrs.org/content/dam/ifrs/knowledge-hub/resources/tpt/disclosure-framework-esrs-comparison-oct-2023.pdf

Recommendation 5: Achieve globally consistent corporate emissions data, including Scope 3 emissions

The standardisation of corporate disclosure through common and audited sustainability-related metrics is a critical component of the EU sustainable finance action plan. Over time, this approach will generate higher volumes of data, with improved quality, which is key for investors assessing companies' contributions to the transition to net zero.

However, despite these advancements, several challenges need to be addressed to ensure the effectiveness of corporate reporting, particularly in relation to transition plans. One of the most significant challenges in corporate reporting is the accurate and consistent disclosure of Scope 3 emissions.

Inconsistent and volatile Scope 3 reporting practices

While Scope 3 emissions are often the largest component of a company's carbon footprint, they are the most challenging to measure and report accurately.

This can mainly be explained by the complexity of emissions exposures. Scope 3 emissions require a granular understanding of corporates' indirect emissions, which encompass companies' entire value chain, including upstream and downstream activities like purchased goods, transportation, and the use of sold products. These emissions, occurring outside companies' direct operations, are much harder to quantify accurately and generally require a lot of assumptions and estimates. For many companies, gathering this level of detailed information is challenging due to the complexity of global supply chains and the limited availability of high-quality, consistent data.

In addition, under the GHG Protocol, companies must independently determine which of the 15 sub-categories of Scope 3 emissions to report on, based on their judgment of materiality. This can be challenging for many, given the limited guidance on identifying the main sources of emissions.

LSEG research shows that most companies do not report on the most material Scope 3 categories, and a high proportion of corporates change which Scope 3 sub-categories they report each year. Of the roughly 4000 listed companies included in the FTSE All World, 45% disclose Scope 3 data, but less than half of them (just 20%) cover the most material categories for their sector, making the reporting highly volatile.

The poor-quality and highly volatile nature of corporate Scope 3 emissions reporting makes it challenging for investors to compare and understand corporate carbon exposure across their portfolios and take associated investment decisions or stewardship actions.

Support companies with clear guidelines for identifying the most material categories of Scope 3 emissions

LSEG strongly supports EFRAG efforts to guide corporates in the reporting of their two or three most material Scope 3 emissions within the 15 categories defined by the GHG Protocol for any given sector.

To do so, LSEG encourages the European Commission and EFRAG to continue working in close collaboration with ISSB and GRI to also ensure alignment on sector specific guidance. Indeed, research indicates that on average across sectors, the two most material categories of Scope 3 emissions account for approximately 81% of the total emissions, and the three most material cover 89%[24]. It is important to emphasise that this is positioned as guidance as many companies may have significantly different business models and hence may have different material sub-categories to other companies in their sector, so will need some flexibility.

Implementing this approach would simplify the reporting for issuers. By focusing on the most material emissions categories relevant to their sector, companies can reduce their reporting burden, making the process more manageable and efficient. This will also improve data usability by concentrating on the most significant emissions categories, enhancing the relevance and comparability for investors and other stakeholders.

It is also important that these issues be addressed with the GHG Protocol as many jurisdictions refer to the GHG Protocol in their climate-related reporting standards. If each jurisdiction manages this on its own, it will create more fragmentation, with different approaches causing more barriers and costs.

[24] https://www.lseg.com/en/ftse-russell/research/solving-scope-3-conundrum

Recommendation 5: Achieve globally consistent corporate emissions data, including Scope 3

5.1 LSEG recommends EFRAG and the European Commission take forward work to set clear sector-specific guidance on the most material Scope 3 emissions categories in close partnership with the ISSB and GRI using the GHG Protocol Corporate Standard.

Key references and sources:

- LSEG (2024). Scope for improvement: Solving the Scope 3 conundrum, available at https://www.lseg.com/en/ftse-russell/research/solving-scope-3-conundrum
- IIGCC (2024) Discussion Paper: Investor approaches to Scope 3: its importance, challenges and implications for decarbonizing portfolios, available at https://www.iigcc.org/resources/iigcc-scope-3-emissions-paper

Achieve climate leadership and transparency at the sovereign level through national transition plans

Private finance alone cannot achieve the net zero transition. Clear public policy signals and direct economic and fiscal interventions are essential across the globe.

Sovereign entities, as key drivers of the Paris climate agreement targets, must not only encourage private actors to develop credible transition plans, but also support them with their own clear transition plans. The private sector's ability to transition depends significantly on operating in countries with effective, well-coordinated transition plans, targets and associated credible short-term and long-term policies to achieve them.

Given the strong interdependencies between government-led decarbonisation strategies and private-sector transition plans, a coordinated approach is crucial for effectively achieving national climate goals. Clarity over national transition planning, better enables the private sector to develop their own climate transition plans; which is relevant for EU states but also internationally.

Lack of transparency and clarity on how sovereigns will meet their transition and adaptation objectives

There can be a lack of transparency and clarity regarding how sovereigns will meet their transition and adaptation objectives. This, coupled with the fact that there are disparate situations across Member States, can undermine the overall effectiveness of the EU transition.

In many cases the targets set out by each country – the "Nationally Defined Contributions" (NDCs) – are insufficient to achieve EU 2030 and 2050 targets and/or are not underpinned by detailed plans and credible policies to achieve them. Based on the LSEG Net Zero Atlas, LSEG projects that, by 2030, EU's current policies will result in the overshooting its NDC by 22%, or 444 MtCO2, surpassing its 1.5°C emissions budget by 2035.

This illustrates the mis-match between longer term ambition and nearer term policies. To improve the situation, practical EU guidance for national transition and adaptation strategies – with an efficient mechanism to ensure their enforcement – should encourage Member States to disclose quantifiable and detailed information.

Track national commitments on a yearly basis

To provide confidence to both the corporate and finance sector, it would be useful that European governments set out how they will achieve their climate objectives on a yearly basis. It is also vital that policy interventions are transparent, clear, and predictable. Tracking national commitments and their implementation are important to hold sovereigns accountable. Institutional investors who are buying government bonds are also becoming focused and organised around how they can better engage governments on their climate policies. This is because bond holders providing capital to those countries are also exposed to potential impacts of climate on default risk.

Tools like LSEG's Implied Temperature Rise (ITR) model and the annual Net Zero Atlas can help investors assess the commitments of individual countries concerning global climate goals and can be used to inform engagement with sovereigns.

In addition to national transition plans, adaptation strategies that include clear information on a country's climate vulnerabilities and resilience strategies, are also critical. However, these remain underdeveloped and heterogeneous across European countries. Effective adaptation planning is essential to reduce the negative impacts of climate change and build resilience to climate-related shocks. As continued enhancement, it is also essential to include more robust and coordinated financial strategies and fiscal policies into national transition plans.

EU institutions could monitor and report the progress of Member States in delivering their NDCs on a yearly basis ideally against national transition plans. This annual information would provide (a) the business and finance sector the confidence to set their own net zero plans and targets and (b) institutional investors who have sovereign bond portfolios with the detail needed to better assess sovereign climate risks.

Finally, there is also an opportunity to better connect government-led emissions data – including that collected for its national inventory reports, the emissions trading scheme and for the carbon border adjustment mechanism – for usage by companies in their reporting processes especially on Scope 3 reporting. This could also be an area for international collaboration.

Achieve climate leadership and transparency at the sovereign level

LSEG encourages EU countries to strengthen the detail contained in their national energy and climate plans (NECPs) to provide the underlying goals and sub-level targets that underpin their nationally determined contributions (NDCs) and set out their adaptation plans in relation to the physical impacts of climate change.

While we acknowledge that the European Commission monitors progress biannually, LSEG encourages EU institutions to establish a mechanism to monitor and report the progress of Member States in delivering their NDCs on a yearly basis. This would provide businesses and finance sector the confidence to set their own net zero plans and targets, and it enables institutional investors who have sovereign bond portfolios to better assess sovereign climate risks and allocate capital.

LSEG also encourages EU institutions to add practical guidance to improve the comparability and comprehensiveness of national transition and adaptation strategies including quantifiable information. An additional opportunity to explore is making available detailed national level emissions data and the data that is collected for CBAM for usage by companies in their reporting processes.

Key references and sources:

- LSEG (2024). COP 29 Net Zero Atlas, available at: https://www.lseg.com/en/insights/cop29-net-zero-atlas
- LSEG (2024). Evaluating national climate commitments using implied temperature rise, available at: https://www.lseg.com/en/ftse-russell/research/evaluating-national-climate-commitments

The EU sustainable finance framework provides a strong foundation for driving positive change, but it must evolve to remain effective and competitive. Collaboration among policymakers, regulators, and industry stakeholders will be crucial in shaping its future. LSEG is keen to engage actively in this dialogue, contributing pragmatic solutions and fostering partnerships to support a more sustainable and resilient financial system.

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