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The Analysis of Regulation on Sustainability in Financial Sector in Lithuania

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***Abstract*—**The Republic of Lithuania is known as a trusted location for global business institutions and it attracts investors with its competitive environment for financial service providers. Along with the aspiration to offer a strong results-oriented and innovations-driven environment for financial service providers, Lithuanian regulatory authorities consistently implement the European Union's high regulatory standards for financial activities including sustainability-related disclosures. Since the European Union directed its policy towards transition to a climate-neutral, green, competitive and inclusive economy, additional regulatory requirements for financial market participants are adopted: disclosure of sustainable activities, transparency, prevention of greenwashing, and other. The financial sector is one of the key factors influencing the implementation of sustainability objectives in the European Union policies and mitigating the negative effects of climate change – public funds are not enough to make a significant impact on sustainable investments, therefore directing public and private capital to green projects may help to finance the necessary changes. The topic of the study is original and has not yet been widely analyzed in Lithuanian legal discourse. There are used quantitative and qualitative methodologies, logical, systematic and critical analysis principles, hence the aim of this study is to reveal the problematic of the implementation of regulation on sustainability in the Lithuanian financial sector. Additional regulatory requirements could cause serious changes in financial business operations: additional funds, employees and time have to be dedicated in order the companies could implement these regulations. Lack of knowledge and data on how to implement new regulatory requirements towards sustainable reporting causes a lot of uncertainty for financial market participants. And for some companies it might even be an essential point in terms of business continuity. It is considered that the supervisory authorities should find a balance between financial market needs and legal regulation.

***Keywords*—**Financial, market participant, legal, regulation, sustainability.

I. Introduction

THE European Union and its member states joined two major international agreements – the United Nations General Assembly 2030 Agenda for Sustainable Development [1], and the Paris Agreement [2]. The 2030 Agenda for Sustainable Development sets out 17 Sustainable Development Goals (SDG). It is aimed to pursue a life of dignity for all within the planet's limits, economic prosperity and efficiency, peaceful societies, social inclusion and environmental responsibility. The Paris Agreement aims to strengthen the global response to the threat of climate change. One of the ways of achieving it is to hold the increase in the global average temperature to well below 2 °C and put efforts to keep the temperature increase to 1.5 °C, identifying that this would lower the dangers of climate change (the Paris Agreement Article 2). The European Union has strongly committed to implement these objectives set in the international agreements and thus has set high goals, including the goal to become the first climate-neutral economy and society by 2050 [3], and embarked on a systematic path towards sustainability. Sustainability requirements at the European Union level have affected most of its concerned areas, including energy, agriculture, transport, finance and other. It is estimated that the financial sector can significantly contribute to the implementation of sustainability goals, since the funds of the public sector are not enough to implement sustainable projects, hence the attracted private capital can have a significant impact on achieving the European Union's sustainability goals. It was noted in the European Green Deal that although much has already been done towards the set sustainability goals, however even more ambitious climate actions should to be set in the coming decade. Meanwhile, one of the efforts to adapt to climate change is to continue to influence public and private sector investments, including on nature-based solutions [3]. For that purpose, the European Union has initiated adoption and changes of legal acts, in order that the regulation would include requirements for sustainability in the activities of financial market participants (from design to implementation and reporting [4]).

Lithuania is the European Union member state since 2004, therefore legal acts adopted by the European Union are also implemented in Lithuania. Moreover, Lithuania is known as a trusted location for global business institutions and it attracts investors with its competitive environment for service providers. Financial market participants are also business entities that provide financial services, such as investment services, insurance and other, where one of the business goals is the pursuit of profit.

Financial activities are regulated and supervised by supervisory authorities operating in the member states. Therefore, financial market participants, when conducting their business, must perform their activities in such a way that it meets the requirements of legal acts and comply with the regulation. After the inclusion of sustainability requirements in the legal acts, new compliance requirements related to the implementation of sustainability requirements appeared for financial market participants in their activities. When conducting activities, financial market participants have to allocate additional resources (knowledge, employees, costs and other) in order to disclose sustainable activities, act

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transparently, take preventive measures to avoid greenwashing activities and other. Therefore, the question then arises as what are the challenges of sustainability-related regulatory implementation in the financial sector.

A. Objective of the Study

The objective of this study is to reveal the problematic of the implementation of regulation on sustainability in the financial sector in Lithuania.

B. Research Methodology

The quantitative and qualitative analysis methodology of the available material is used, as well as the principles of logical, systematic and critical analysis. The research methodologies and principles are used to evaluate the aims, proposals, attitudes, and opinions of legislators, regulators and researchers on the sustainability regulation in the financial sector, and the implementation of the sustainability regulation in the financial sector is examined.

II. Regulation on Sustainability in Financial Sector

One of the most important legal acts regarding the regulation of sustainability objectives in the financial sector is the European Union Regulation on sustainability-related disclosures in the financial services sector [5] (hereinafter – SFDR) and the European Union Regulation on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 [6] (hereinafter – Taxonomy Regulation). The SFDR determines that financial market participants that carry out investment activities shall act in transparent way, for example adopt policies on the integration of sustainability risks in their investment decision-making process [7], disclose information about sustainable investments to investors, also integrate sustainability risks in their activities both on entity and product level and other. Besides other regulatory opinions and consultation papers, the SFDR is supplemented by regulatory technical standards [8] specifying the details of the content and presentation of the information that must be prepared by the financial market participants.

The Taxonomy Regulation supplements the SFDR and determines the criteria for assessing whether economic activity is environmentally sustainable and to what extent an investment is environmentally sustainable (Taxonomy Regulation Article 1). Moreover, this regulation introduces the financial sector and all the legal system with a new institute – the greenwashing. In the Taxonomy Regulation the greenwashing is explained as the activity when an unfair competitive advantage is gained by marketing a financial product as environmentally friendly, when in practice the basic environmental standards are not followed (Taxonomy Regulation Preamble 11).

These mentioned legal acts are aimed at financial market participants performing investment activities. Accordingly, these legal acts are also applicable in Lithuania. It should be noted that the requirements related to sustainability have been either applied directly or transferred to existing legal acts and interpretations. There are also other legal acts that are supplemented with sustainability requirements and are applied to business entities in some such way, for example, Corporate Sustainability Reporting Directive (or known as CSRD) [9].

The objectives related to sustainability and established at the European Union level are not only a concept, the legislator clearly transposes them into legislation, and the supervisory authorities assess how financial market participants have to adhere to them. It is said that we are now at a juncture of legal and regulatory developments where policy choices need to address how finance should connect with the wider public interest and social good in sustainability outcomes – what is the role of "core valued goals" in sustainable finance? [10]

III. Problematics with the Sustainability Regulation Implementation in Financial Sector

Generally, all the parties participating on the sustainability regulation in the financial sector (the legislator, the regulator, the financial business entities, private investors and other financial market participants) might meet the challenges related to this regulation because the sustainability regulation is a new occurrence in the legal system. Neither the legislator, nor the regulator or any other financial market participant could expect what challenges this new regulation would bring. Therefore, the legislative authority can make certain conclusions on how the law works when it is applied and consequently what needs to be more developed. The creation of law is a dynamic process and the further problematics faced by financial market participants are analyzed both in public government and private business level.

Starting the effect date of the mentioned legal acts (the SFDR is applicable since 10 March 2021, the Taxonomy Regulation is applicable since 12 July 2020), financial market participants have to ensure that their activities and documents contain the information indicated at the legal acts, and that the sustainability reports reflect the required information. However, financial market participants may face unforeseen challenges when implementing sustainability requirements.

Several challenges faced by business (financial market participants) while implementing sustainability-related regulation can be identified. First to mention, insufficient resources – financial market participants faced with the new regulation did not estimate how much compliance to sustainability regulation might cost them in additional personnel, knowledge/learning or the need to hire external consultants that specialize in sustainability regulation, or attend the courses on implementation of SDG into their business activities. This issue arises when it is not clear how and on what terms to fill out the necessary reports about financial products and entities, what necessary documents on product and entity level should be prepared, what information should be included in them, what is a need for resources for additional information technologies and other. The lack of additional funds may result in that financial market participant cannot meet the sustainability requirements or the requirements will impose too great financial burden on it to continue business activities (when expenses become greater than income).

When a new project is being developed, where all processes are being designed, it might be easier to take sustainability

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requirements into account (e.g. estimation of CO_2 emissions). However, this is more complicated when the financial product has already been created (hypothetical example, funds are fundraised for a high energy efficiency class building and the project was presented to the investors as a sustainable project that it is possible to say complies with the SFDR Article 8, as a financial product that promotes environmental or social characteristics, so-called “light green” [11] product). In such situation, financial market participants should consider how to ensure and achieve sustainability requirements for the already existing product and ensure that the structure companies incorporate the sustainability factors into their decision-making processes and supply chain, i.e. the “sustainable investment value chain” [12]. On the other hand, it might be thought that such project ought to be redesigned to non-green project so that it would not mislead the investors. However, even though the investment product would not be considered to be sustainable, the principle “comply or explain” is still applicable. It means that the financial market participant has to explain why the sustainability factors are not integrated into investment decisions and whether and when it is planned to integrate them (SFDR Article 4, Article 6).

Second issue is the missing information from the legislator and regulator. Although the legal acts are valid, but in the absence of practice, it is not clear how and what information is required to be submitted for the supervision. It is not clear whether the collected information is sufficient and accurate. It could be said that the lack of information and practice could possibly lead to misinterpretation of regulation and the greenwashing: corporate GHG (i.e. greenhouse gas) reporting is currently far from perfect and will likely remain imperfect without significant intervention as corporations lack incentives to report bad deeds accurately [14]. For example, the same high energy efficiency class building – if the investment company of this financial project is not transparent enough and not declare sustainability requirements to the investors, or declare them but not in full extent just in order to comply with the legal requirements, or uses building materials in some part of the sustainable investment value chain that is not compliant with sustainable project’s pre-contractual disclosures that were issued for the investors, the investment company might be accused for performing greenwashing activities. Consequently, neither it is clear yet, who should be responsible for ensuring that the greenwashing is not carried out in the investment company's activities: the management or specialists that are delegated to take investment decisions, and which supervisory authority should impose the responsibility.

For comparison, for General Data Protection Regulation [14] (or known as GDPR) violations, fines are imposed by delegated authorities (GDPR Article 51), for money laundering violations, fines or other enforcement measures imposed by competent national AML/CFT (i.e. Anti-Money laundering/ Countering the Financing of Terrorism) supervisory authorities. Meanwhile, for non-compliance with the sustainability requirements, the supervision function currently is performed by local financial supervisory authorities. However, non-compliance with sustainability requirements includes not only violations of financial regulation, but also damage for nature, people discrimination (for example, regards to gender, age or beliefs) and other factors. Thus, it is discussed that the legislator should provide more clarifications regarding supervision of sustainability compliance.

Further aspect relevant to business entities is how to convince investors that respecting sustainability requirements will pay off with better returns in the long term. It might be thought that sustainability related spending (expenses) is a cost — not investment. Therefore, investors might hesitate to be investing in the future of the business and climate change mitigation: some analysts have argued that macroprudential initiatives following the financial crisis, notably Basel III, seem to promote short-term “brown” investments at the expense of more long-term, climate-friendly investments. In particular, it is noted that liquidity requirements might negatively affect banks' willingness to lend to green projects [15]. However, it is suggested to look at a longer-term perspective, since sustainable business and investments have a greater resilience strategy and ESG (i.e. environmental, social governance) stress testing.

It is also worth noting that the regulatory attitude is moving towards even greater tightening of legislation, as the climate changes come faster than the market can take measures to control it. Therefore, those businesses that are already making maximum efforts to implement sustainability requirements, even if they cost a lot of investments, will have fewer obstacles soon in implementing even stricter legal requirements if such are adopted.

To sum up, sustainability regulation is in place, but not complete and in need of improvement. Several reasons could be highlighted – the lack of practice of applying sustainability regulation in the market, and the lack of clarity what even stricter measures the legislator will have to take to achieve the set goals towards climate change mitigation. Researchers may argue for some incompleteness of laws or collect data on laws that are functioning inefficiently [16], but the financial sector also needs solutions that are not easily and immediately accessible, but that may already have an efficiency.

Currently financial market participants are burdened with a strict compliance to sustainability requirements, however, it is not estimated how many businesses can bear such a burden, for which entities it might be too heavy and may even lead to bankruptcy. Therefore, it can be assumed that the legislator should also maintain a balance of interests – the global good for mitigating climate change and the right to provide financial services, and look for ways how to help business to follow the recently adopted large number of legal requirements related to sustainability.

IV. Conclusion

The European Union regulation towards sustainability is applicable to every member state including the Republic of Lithuania. Regulation on sustainability details the objectives of SDG and sets transparency, reporting requirements, identifies the greenwashing activities for the financial market participants (including business entities). Due to the lack of sustainability regulation application practice, the problematics of the

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application of the sustainability regulation is revealed not only on the scale of the country, but on the scale of the entire European Union. Adapting and following these laws is quite difficult for business entities. Financial market participants are faced with the questions of how to properly interpret the regulation, how to get additional funds to implement this regulation, and how to convince investors that investments in sustainability will pay off in the long term and that this is an investment for the future good.

On the other hand, incorrect application of sustainability requirements can cause misunderstanding in the market and even lead to violations of the law. Considering the fact that the new regulation sets many new rules for financial market participants, the regulatory authorities should consider a way how to support the business in this transitional period when moving to compliance to strict sustainability requirements.

Moreover, despite the problematics met by the legislator, the regulator, the financial business entities, private investors and other financial market participants, the regulation norming the SDG objectives is in force and helps to achieve the sustainability goals set by the European Union, even though this regulation might be considered as still in progress.

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